Supreme Court, U.S.
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No. 07-684

IN THE

Supreme Court of the United States

LIBERTY ELECTRIC POWER, LLC,

Petitioner,

v.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.),

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

In a bankruptcy case, may a federal court rely on purported equitable principles to reject a creditor's claim, where the claim is otherwise valid under state law and the creditor is not alleged to have engaged in wrongdoing or inequitable conduct?

PARTIES AND CORPORATE DISCLOSURE STATEMENT

The parties to the proceeding in the court below are as set forth in the caption of the case.[1]

Liberty is wholly owned by Liberty Electric PA II, LLC.

1. John L. Daugherty, Trustee, was incorrectly identified as an appellee in the caption of the Fourth Circuit's decision. Mr. Daugherty was not a party at any stage of this adversary proceeding, and is not a party to this petition for certiorari.

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Liberty Electric Power LLC ("Liberty") respectfully petitions for a writ of certiorari to review a judgment of the United States Court of Appeals for the Fourth Circuit.

OPINIONS BELOW

The Court of Appeals' opinions (Appendix to the Petition ["App."] 1a-18a) are reported at 492 F.3d 297. The opinions of the district court (App. 19a-20a) and the bankruptcy court (App. 25a-37a) are not reported.

JURISDICTION

The judgment of the Court of Appeals was entered on July 10, 2007. A petition for rehearing and for rehearing en banc was denied on August 6, 2007. *See* App. 38a-39a. By order dated October 26, 2007, this Court extended the time for Liberty to file a petition for a writ of certiorari until December 5, 2007. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 502(b)(2) of the Bankruptcy Code provides that if an objection is made to a claim submitted in a bankruptcy case:

> the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that such claim is for unmatured interest.

11 U.S.C. § 502(b)(2).

STATEMENT OF THE CASE

1. At issue in this bankruptcy case is whether a federal court may rely on purported equitable principles to reject an otherwise valid claim, where there has been no inequitable conduct by the creditor. The claim rejected by the Fourth Circuit arises from a guaranty. A guaranty is an agreement requiring one entity, the guarantor or surety, to answer for the debt of another entity, the borrower or primary obligor. By making another entity jointly and severally liable for a debt, guaranties protect commercial creditors against the risk of default by the primary obligor. Moreover, guaranties enable the creditor to collect from a solvent guarantor amounts that could not be collected from the primary obligor if it were to go into bankruptcy, such as interest accruing on an unsecured debt after a bankruptcy commences. *See* 11 U.S.C. § 502(b)(2). Absent an express agreement to the contrary, a creditor is entitled under state law to allocate a payment from a guarantor first to accrued interest, and then to principal. *See United States v. Pollack*, 370 F.2d 79, 80 (2d Cir. 1966).

Liberty procured a guaranty that was capped by contract at an amount that did not satisfy the debt in full. Liberty allocated a payment under the guaranty first to interest, then principal, and sought to recover the outstanding principal from the primary obligor, which had commenced a bankruptcy case. Invoking a putative equitable authority to disallow claims, the court below disregarded Liberty's allocation of the guarantor's payment, deemed the unpaid portion of the debt to be interest rather than principal, and rejected the claim on the ground that post-bankruptcy interest on an

unsecured claim may not be collected from a debtor's estate. *See* 11 U.S.C. § 502(b)(2). The question is whether a federal court has such equitable authority, where, as here, the creditor is not alleged to have engaged in any misconduct or wrongdoing.

2. In April 2000, Liberty, an energy-generating company, entered into an agreement ("Agreement") with National Energy & Gas Transmission Energy Trading Power, L.P. ("ET Power"), under which ET Power secured the right to purchase energy from Liberty in exchange for a monthly payment. To back up ET Power's financial obligations under the Agreement, Liberty procured a limited guaranty of payment ("Guaranty") from ET Power's affiliate, Gas Transmission Northwest Corporation ("GTN"). The Guaranty provided that GTN would pay "all amounts payable by [ET Power] under the Agreement," subject to a $140 million cap. Under New York law, which governs both the Agreement and the Guaranty, "GTN was a surety for ET Power's obligations to Liberty." App. 8a.

In July 2003, ET Power commenced a voluntary case under chapter 11 of title 11 of the United States Code ("Bankruptcy Code"), and immediately rejected its Agreement with Liberty. After an arbitration to determine Liberty's damages from rejection of the Agreement, Liberty was awarded damages of $140 million — coincidentally, the same amount as the cap on GTN's guaranty liability — plus interest that continued to accrue after the filing of the bankruptcy petition. Because the Bankruptcy Code disallows claims against a debtor for interest accruing on an unsecured debt after a bankruptcy petition is filed, *see* 11 U.S.C. § 502(b)(2),

Liberty sought to recover from the bankruptcy estate only $140 million — the amount of its petition-date damages, without any subsequently accruing interest.[2]

Liberty also attempted to collect the arbitral award from ET Power's surety, GTN. Because the Agreement expressly provided that in the event of a default, ET Power would be liable for "such amount plus interest," Agreement § 14.2(c), and the Guaranty provided that GTN would be liable for "all" amounts payable by ET Power, GTN too was liable to Liberty for principal and interest, subject to the contractual cap. Liberty received $140 million pursuant to the GTN Guaranty.[3] *See* App. 4a-5a.

The $140 million payment fully satisfied GTN's capped guaranty liability, but did not fully satisfy the underlying debt as determined by the arbitral award, which, with accrued interest, had grown to approximately $157 million. The standard practice by

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2. Liberty's total claim against ET Power's bankruptcy estate was actually higher. In addition to the debt at issue here, ET Power owed Liberty approximately $5.4 million in unpaid invoices at the time it petitioned for bankruptcy protection. In the interest of simplicity, that separate debt is ignored in this petition for certiorari, as it was in the decision below, *see* App. 4a n.2, 5a n.3, but Liberty is entitled to recoveries on that debt from the bankruptcy estate regardless of the outcome of this petition.

3. During the pendency of the arbitration, GTN, which remained solvent and never commenced a bankruptcy case, had been sold to another entity; as part of this transaction, $140 million had been reserved in escrow to provide for any liability to Liberty. Liberty received payment on the Guaranty from this escrow account. *See* App. 4a-5a, 28a & n.3.

creditors is to apply payments on a debt first to accrued interest and then, if any portion of the payment remains, to principal. *See, e.g.*, *Darr v. Muratore*, 8 F.3d 854, 861 (1st Cir. 1993) (collecting cases); *Story v. Livingston*, 38 U.S. 359, 371 (1839). Liberty did just that, allocating the first $17 million of GTN's payment to accumulated interest, and the remainder to principal. Thus, approximately $17 million of principal remained unpaid following GTN's payment.

3. After receiving partial satisfaction of the arbitral award from GTN, Liberty continued to press its claim against ET Power's bankruptcy estate. *See* App. 21a-24a. While asserting the full allowable amount of the arbitral award (*i.e.*, the full amount of petition-date damages but not the unallowable post-petition interest), Liberty acknowledged that it could collect at most $17 million, the amount of principal left unpaid after GTN's payment, since it is entitled to no more than one full satisfaction of the award from all sources.

ET Power opposed any recovery by Liberty from the bankruptcy estate, arguing that as a result of GTN's payment, Liberty's claim against the estate had been reduced to $17 million, the amount outstanding on the debt. ET Power further argued that this remaining amount must be deemed post-petition interest, not principal, and therefore must be disallowed under section 502(b)(2) of the Bankruptcy Code, which bars unsecured claims for interest accruing after a bankruptcy petition was filed. *See* App. 29a-30a. Liberty responded that its allowable claim against the estate was not reduced by GTN's partial satisfaction of the underlying debt, and that it had properly allocated GTN's payment first to interest, then to principal.

The bankruptcy court agreed with Liberty. It held that GTN, as a non-debtor guarantor, was liable for post-petition interest, and that Liberty was free to allocate GTN's $140 million payment first to the $17 million of post-petition interest and then to $123 million of principal, leaving a $17 million principal debt unpaid. *Nat'l Energy & Gas Transmission, Inc. v. Liberty Elec. Power, LLC*, No. 03-03104 (Bankr. D. Md. June 27, 2005). The district court affirmed. *Nat'l Energy & Gas Transmission, Inc. v. Liberty Elec. Power, LLC*, No. 05-2531 (D. Md. March 6, 2006).

4. A divided panel of the Fourth Circuit reversed, with three separate opinions. *Nat'l Energy & Gas Transmission*, 492 F.3d 297. The Fourth Circuit's reversal was not based on any determination that the facts found by the lower courts were clearly erroneous. Thus, all three judges on the Fourth Circuit panel acknowledged, as the lower courts had, that as against GTN, Liberty could allocate the $140 million payment first to interest and then to principal, and gave no reason to think that that this allocation would be invalid outside of bankruptcy. *See* App. 11a n.5; 13a; 18a. However, two judges ruled that under principles of equity, Liberty's allocation would be ineffective against ET Power's bankruptcy estate — and thus that the $140 million principal debt would be deemed fully paid, leaving no further allowable claim against the estate. *See* App. 12a, 13a.

The lead opinion first rejected ET Power's contention that Liberty's claim against the bankruptcy estate must be reduced in light of the payment from GTN. *See* App. 7a (citing *Ivanhoe Building & Loan Ass'n*

v. Orr, 295 U.S. 243 (1935) for the proposition that a creditor need not deduct from its claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation); App. 8a (holding that under the governing New York law, GTN's payment did not reduce the amount of ET Power's debt to Liberty).

But the majority nonetheless barred Liberty from collecting from the bankruptcy estate any of the outstanding $17 million, holding that any funds received would constitute post-petition interest disallowed by 11 U.S.C. § 502(b)(2). The lead opinion did not dispute Liberty's contractual right to allocate GTN's payment first to interest, then to principal, outside of the bankruptcy context. *See* App. 11a n.5 ("Liberty is free to classify GTN's payment as interest"). But the court concluded that for purposes of bankruptcy, "principles of equity" required it to disregard Liberty's allocation of the payment from GTN, and instead to treat the entire payment as principal and the outstanding amount as post-petition interest:

> The § 502(b)(2) bar to collection of interest is not overcome by Liberty's classification of the $17 million it now seeks as principal. . . . Because ET Power's debt was capped at $140 million by the filing of the bankruptcy petition and because the debt was increased only by the accrual of interest pursuant to the arbitration award, we view Liberty's claim for an additional $17 million as disallowed post-petition interest no matter how Liberty chooses to classify it.

App. 11a.

Although it expressly relied on "principles of equity" to reach this result, nowhere did the majority find that Liberty had engaged in any type of inequitable conduct — and indeed such a finding would have been impossible on this record, since Liberty is not even alleged to have engaged in misconduct, and no finding of misconduct was made by the district court or the bankruptcy court, both of which had permitted Liberty to collect the outstanding $17 million.

The concurring opinion noted that the lead opinion did not contest "Liberty's contractual rights under its guarantee from GTN to allocate principal and interest in any fashion it sees fit in relation to GTN." App. 13a-14a n.* (Wilson, J., concurring in the judgment). Without further explanation, however, the concurring opinion concluded that Liberty could not "allocate its way around § 502(b)(2)'s disallowance of unmatured interest." App. 13a.

The dissenting opinion objected that the majority's holding was irreconcilable with "ample authority . . . to the contrary." App. 14a. The dissent started "with the basic principle of contract law that Liberty is entitled to be paid in full, including interest, by its jointly and severally liable debtors." App. 15a. "[I]t is . . . well-settled," the dissent continued, "that § 502(b)(2) has no impact on the accrual of unmatured interest against non-debtors, including non-debtor guarantors." App. 15a (citing cases). Yet, the dissent noted, "the majority would have the bar to recovery of interest from the debtor swallow the accrual of interest on the debt across all parties liable for it." App. 16a. The dissent also cautioned that this result appeared to violate section 524(e) of the

Bankruptcy Code, which provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on ... such debt." App. 17a. Unlike the majority, the dissenting judge "fail[ed] to see the unfairness in the fact that Liberty bargained, outside of bankruptcy, for a guarantee of payment. That other creditors may not have secured such a guarantee, and therefore might ultimately recover proportionally less than Liberty, strikes me as no injustice." App. 17a.

Liberty petitioned for rehearing and rehearing en banc in July 2007. The petition was denied on August 6, 2007, with the same judge again dissenting. App. 39a.[4]

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4. Although no final judgment has been entered in the underlying bankruptcy proceeding, that is no obstacle to this Court's review. Where, as here, a petition for certiorari presents an "important and clear-cut issue of law," R. STERN, E. GRESSMAN, S. SHAPIRO & K. GELLER, SUPREME COURT PRACTICE, SUPREME COURT PRACTICE 196 (7th ed. 1993), and the rule of law announced by the circuit court will not be altered or refined by ongoing proceedings below, then such proceedings do not affect this Court's review. Indeed, "bankruptcy proceedings justify a distinctive and more flexible definition of finality." 16 CHARLES ALAN WRIGHT, ARTHUR MILLER & EDWARD H. COOPER, FEDERAL PRACTICE AND PROCEDURE § 3926.2, at 271 (2d ed. 1996). Accordingly, this Court has not hesitated to hear bankruptcy cases even where, as here, there has not yet been a final distribution from the bankruptcy estate. *See, e.g.*, *FCC v. NextWave Pers. Commc'ns Inc.*, 537 U.S. 293 (2003) (opinion of this Court issued on 1/27/03); *United States ex rel. Finney v. Nextwave Telecom, Inc.*, 337 B.R. 479, 484 (S.D.N.Y. 2006) (stating that the reorganization plan was approved on 3/1/05).

REASONS FOR GRANTING THE PETITION

The decision below warrants this Court's review because it conflicts with prior decisions of this Court and the lower federal courts governing creditors' entitlements in bankruptcy; displaces state law in a manner that unduly disrupts rational commercial expectations; and needlessly increases the cost of credit.

The Fourth Circuit's decision creates a three-way conflict among the circuits regarding when, if at all, a federal court may rely on equitable principles to disallow an otherwise valid claim in bankruptcy. The Fifth Circuit permits only equitable subordination — not equitable disallowance — of claims, so a claim found to be inequitable will be allowed but given lower priority than other claims. Five other Circuits permit equitable disallowance of claims, but only upon a finding of fraud or other inequitable conduct by the creditor. Under the Fourth Circuit's decision, in contrast, a federal court may disallow, not merely subordinate, a claim on equitable grounds, and do so even where the creditor has engaged in no fraud or misconduct of any kind.

The decision below also conflicts with well-established precedents from this Court and at least six federal courts of appeals governing the relationship between state law and federal bankruptcy law. Just last term, in *Travelers Cas. & Surety Co. v. Pac. Gas & Elec. Co.*, 127 S. Ct. 1199 (2007), this Court reiterated that a claim that is valid under state law is allowable in bankruptcy unless the Bankruptcy Code expressly disallows it. Outside bankruptcy, Liberty was concededly entitled to allocate its $140 million payment from GTN

first to $17 million of interest and then to $123 million of principal, leaving $17 million of principal unpaid. But the Fourth Circuit created a new bankruptcy rule disregarding Liberty's valid state law allocation and deeming the unpaid portion of the claim unallowable interest, despite the absence of any explicit directive in the Bankruptcy Code requiring this result.

In addition, review of the decision below is imperative because of its adverse impact on the commercial credit market. The Fourth Circuit's reliance on a muddled equitable calculus to override Liberty's allocation of its guaranty payment will bring substantial uncertainty to the well-settled rights of creditors, debtors, and their guarantors in bankruptcy cases. Because this uncertainty undermines the value of commercial guaranties, it inevitably will raise the cost of credit, making credit less available. It thus presents a question of exceptional importance meriting this Court's attention.

I. The Decision Below Conflicts with the Precedents of This Court and Other Federal Courts of Appeals.

A. The Decision Below Conflicts with the Precedents of Other Federal Courts of Appeals Regarding the Appropriate Use of Equitable Principles to Disallow Claims in Bankruptcy.

The Fourth Circuit relied on "principles of equity" to reject Liberty's claim against ET Power to collect $17 million of unpaid principal — a claim that was concededly valid under applicable non-bankruptcy law — but made no finding that Liberty had engaged in inequitable conduct. *See* App. 9a-10a. Because six other courts of appeals have held that a court's equitable powers may not override a creditor's valid state law entitlement in those circumstances, the Fourth Circuit's decision creates an irreconcilable conflict that must be resolved by this Court.

This Court recognized more than six decades ago that "the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy [may] require[] its subordination to other claims which, in other respects, are of the same class." *Prudence Realization Corp. v. Geist*, 316 U.S. 89, 95 (1942); *see also Mfrs. Trust Co. v. Becker*, 338 U.S. 304, 310-14 & n.7 (1949); *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 228-31 (1948); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 162-67 (1946); *Heiser v. Woodruff*, 327 U.S. 726, 732 (1946); *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219-20 (1941); *Pepper v. Litton*, 308 U.S. 295, 303-11 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 322-23 (1939).

Even before the Fourth Circuit's decision, the lower federal courts were in disagreement as to whether courts

sitting in bankruptcy may rely on principles of equity to disallow, rather than merely subordinate, an otherwise valid claim. *See In re Outdoor Sports Headquarters, Inc.*, 168 B.R. 177, 181 (Bankr. S.D. Ohio 1994) ("Conflicting federal case law exists on the issue of whether a claim may be disallowed upon equitable principles."). The Fifth Circuit has taken the most restrictive view of the sweep of these equitable powers. In *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), the Fifth Circuit identified "two principal bounds" on a federal court's equitable authority in bankruptcy cases. *Id.* at 699. First, under the Fifth Circuit's rule, "equitable considerations can justify only the subordination of claims, not their disallowance." [5] *Id.*; *see also In re Century Inns, Inc.*, 59 B.R. 507 (Bankr. S.D. Miss. 1986); 11 U.S.C. § 510(c)(1) (expressly providing that claims may be subordinated "under principles of equitable subordination," but not providing for equitable disallowance). Second, the Fifth Circuit held that "before exercise of the power of equitable subordination is appropriate," the "claimant must have engaged in some type of inequitable conduct." [6] 563 F.2d at 699-700.

5. The holder of a disallowed claim is entitled to no distributions from the bankruptcy estate under any circumstance. The holder of a subordinated claim is entitled to distributions, but only after creditors with claims of a higher priority have been paid in full.

6. In *Mobile Steel*, the Fifth Circuit imposed two further conditions on equitable subordination: the claimant's misconduct must have injured creditors or given the claimant an unfair advantage, and subordination of the claim must be consistent with the governing statute. 563 F.2d at 700. "This last requirement," this Court observed, "has been read as a reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." *United States v. Noland*, 517 U.S. 535, 539 (1996) (internal quotation marks omitted).

Nearly every other court of appeals — including the Fourth Circuit — has agreed with this second holding, requiring a showing of misconduct by a creditor before equitably subordinating the creditor's claim. *See In re Giorgio*, 862 F.2d 933, 938 (1st Cir. 1988) (Breyer, J.); *Musso v. Ostashko*, 468 F.3d 99, 108-09 (2d Cir. 2006); *In re ASI Reactivation, Inc.*, 934 F.2d 1315, 1321 (4th Cir. 1991); *In re Baker & Getty Fin. Servs., Inc.*, 974 F.2d 712, 717-18 (6th Cir. 1992); *In re Lifschultz Fast Freight*, 132 F.3d 339, 344 (7th Cir. 1997); *In re Bellanca Aircraft Corp.*, 850 F.2d 1275, 1282 (8th Cir. 1988); *In re Dominelli*, 820 F.2d 313, 318-19 (9th Cir. 1987); *In re Castletons*, 990 F.2d 551, 559 (10th Cir. 1993). This Court has recognized but expressly declined to reach the question "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated." *United States v. Noland*, 517 U.S. 535, 543 (1996).

Five courts of appeals permit not only equitable subordination, as the Fifth Circuit does, but equitable disallowance as well. *See In re Madeline Marie Nursing Homes*, 694 F.2d 433, 437 (6th Cir. 1982); *Small v. Beverly Bank*, 936 F.2d 945, 949 (7th Cir. 1991); *Kapp v. Naturelle, Inc.*, 611 F.2d 703, 708 (8th Cir. 1979); *In re Ahlswede*, 516 F.2d 784, 787 (9th Cir. 1975); *In re Four Seasons Nursing Centers of Am., Inc.*, 483 F.2d 599, 602-03 (10th Cir. 1973). *But see Gaff v. Fed. Deposit Ins. Corp.*, 919 F.2d 384, 393 (6th Cir. 1990) (agreeing in dicta with the Fifth Circuit's position that equity "does not disallow the claim, but only subordinates it within the entire set of priorities"). The Second Circuit has suggested in dicta that it, too, would permit the disallowance of otherwise valid claims on equitable grounds alone. *See Musso*, 468

F.3d at 108. The Third Circuit has identified but declined to answer the question. *See Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 991 n.7 (3d Cir. 1998) ("We find it unnecessary here to resolve the issue as to whether equitable 'disallowance' remains an available remedy.").

The Seventh, Eighth, Ninth and Tenth Circuits have explicitly stated that equitable disallowance, like equitable subordination, is available only in cases involving inequitable conduct, such as fraud or other bad faith acts, by the creditor. *See Small*, 936 F.2d at 949 ("a particular claim may be disallowed or subordinated because of the fraudulent nature of the claim, or because of the bad faith or improper conduct by claimant"); *Kapp*, 611 F.2d at 708 ("a claim which has been reduced to judgment" can be equitably disallowed in bankruptcy if "the judgment was procured by fraud or collusion"); *In re Ahlswede*, 516 F.2d at 787 ("[a] supposed inequity resulting when an innocent party in good faith asserts a legally valid claim will not" support an equitable disallowance); *In re Four Seasons Nursing Centers*, 483 F.2d 599, 603 (10th Cir. 1973) ("Merely because a court may be exercising equitable powers [in a bankruptcy case] does not permit it to change the terms of a contract in the absence of fraud, accident or mistake."). The Sixth Circuit appears to have adopted the same limitation, since it treats equitable subordination and equitable disallowance as a uniform doctrine, *see Madeline Marie Nursing Homes*, 694 F.2d at 437 & n.6, and expressly requires creditor misconduct for equitable subordination, *see Baker & Getty Fin. Servs.*, 974 F.2d at 717-18.

The Fourth Circuit's decision below creates a three-way split among the federal courts of appeals over the scope of equitable powers in bankruptcy. In relying on equitable grounds to disallow, not merely subordinate, Liberty's claim to collect $17 million of unpaid principal, the decision below conflicts with the Fifth Circuit's rule that "equitable considerations can justify only the subordination of claims." *Mobile Steel*, 563 F.2d at 699. It also conflicts with the rule set forth by the five circuit courts that permit equitable disallowance of claims only upon a showing of fraud or other inequitable conduct. The Fourth Circuit never found that Liberty had engaged in any fraud or other improper conduct, nor would such a finding have been possible on this record. It is undisputed that the relevant agreements giving rise to Liberty's right to payment were negotiated at arms length, and even the Fourth Circuit acknowledged that Liberty had the right under state law to allocate GTN's payment to interest first, *see* App. 11a n.5, leaving a $17 million principal debt unpaid. "[T]he normal rule throughout the nation is that, absent an express agreement to the contrary, there is a presumption that loan payments are made to interest first and then principal." *Darr*, 8 F.3d at 861. That Liberty followed this "normal rule" was in no way improper or untoward. *See In re W.T. Grant Co.*, 699 F.2d 599, 609 (2d Cir. 1983) ("a creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim") (internal quotation marks omitted).

One consequence of the decision below is that, in the Fourth Circuit, a creditor's claim now may be disallowed entirely under circumstances that, in all other jurisdictions, would not even warrant the lesser remedy

of subordination. Where, as here, the creditor is not an insider of the debtor, courts generally require a showing of egregious creditor misconduct before equitably subordinating a claim. *See In re Giorgio*, 862 F.2d at 939 ("Where a bankruptcy court has subordinated the debt of a creditor who was not an insider, it has done so on the ground that [the creditor's] conduct was egregious and severely unfair in relation to other creditors.") (Breyer, J.); *Baker & Getty*, 974 F.2d at 718 ("Where the claimant is a non-insider, egregious conduct must be proven with particularity" before the claim can be equitably subordinated); *id.* (the objectant "must prove that the claimant is guilty of gross misconduct"). Indeed, even in the Fourth Circuit, a claim cannot be equitably subordinated — *i.e.*, given a lower priority — unless the objectant establishes that "the claimant engaged in fraudulent conduct." *ASI Reactivation*, 934 F.2d at 1321. Yet, under the decision below, the same creditor may have its claim rejected altogether in the Fourth Circuit in the absence of any misconduct at all. This irreconcilable conflict among the circuit courts on an issue of substantial importance for commercial dealings merits resolution by this Court.

B. The Decision Below Conflicts with the Decisions of This Court and the Lower Federal Courts Regarding the Interplay Between State Law and the Federal Law of Bankruptcy.

The Fourth Circuit's novel and broad formulation of the equitable disallowance doctrine places it in conflict not just with the circuits that have addressed the scope of a bankruptcy court's equitable powers, but also with the decisions of this Court and the lower federal courts

holding that a claim which is valid under state law must be allowed in bankruptcy unless the Bankruptcy Code expressly disallows it. Earlier this year, this Court reaffirmed that "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." *Travelers*, 127 S. Ct. at 1206. Other decisions from this Court are to the same effect. *See Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 20 (2000) ("The 'basic federal rule' in bankruptcy is that state law governs the substance of claims"); *Butner v. United States*, 440 U.S. 48, 57 (1979) (same).

Six federal courts of appeals have likewise held that "[a]bsent an overriding federal law, the existence and magnitude of valid claims against a debtor are determined by state law." *In re Exec Tech Partners*, 107 F.3d 677, 680 (8th Cir. 1997); *see also In re Combustion Eng'g, Inc.*, 391 F.3d 190, 245 n.66 (3d Cir. 2004) ("To determine whether claims are enforceable for bankruptcy purposes, § 502 relies upon applicable non-bankruptcy law."); *Carrieri v. Jobs.com Inc.*, 393 F.3d 508, 529 (5th Cir. 2004) ("the validity of a creditor's claims . . . is to be determined by reference to state law") (internal quotation marks omitted); *Matter of A.G. Fin. Serv. Ctr., Inc.*, 395 F.3d 410, 413-14 (7th Cir. 2005) ("Bankruptcy law enforces non-bankruptcy entitlements, unless they are modified according to the Code. Bankruptcy courts lack authority to alter rules of state law, or depart from those in the Code, to implement their own views of wise policy.") (internal citation omitted); *In re Hashim*, 213 F.3d 1169, 1171 (9th Cir. 2000) ("The validity of a creditor's claim against the bankruptcy estate is governed by . . . state law"); *In re Ogden*, 314 F.3d 1190, 1200 (10th Cir. 2002) ("non-bankruptcy substantive law usually determines the existence of a claim").

The Fourth Circuit identified no factor, such as fraud, that might have rendered Liberty's claim for payment of unpaid principal invalid under state law. To the contrary, the court acknowledged Liberty's right outside of bankruptcy to allocate GTN's payment to interest first, leaving $17 million of principal unpaid. *See* App. 11a n.5; App. 12a. The court below also did not identify any provision of the Bankruptcy Code that expressly required it to disregard Liberty's allocation of GTN's payment and to disallow Liberty's claim. The sole provision relied on by the majority merely disallows claims for "unmatured interest." *See* App. 8a-13a (applying 11 U.S.C. § 502(b)(2)). Nowhere does it expressly provide that a creditor's exercise of its contractual right to allocate a guarantor's payment to interest must be set aside by the bankruptcy court. *See* App. 16a ("There is simply nothing in the Bankruptcy Code, applicable case law, the relevant guarantee agreement, or nonbankruptcy law to support the jettisoning of basic contract law principles in favor of an expansive reading of § 502(b)(2).") (Duncan, J., dissenting). Indeed, the most pertinent provision of the Bankruptcy Code would seem to prohibit the Fourth Circuit's equitable re-characterization of GTN's payment as one for principal, instead of interest. Section 524(e) provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on . . . such debt." 11 U.S.C. § 524(e). By allowing a bankruptcy filing to alter Liberty's allocation of its payment from GTN, the majority's holding "appears to expressly violate" this provision. App. 17a (Duncan, J., dissenting).

The Fourth Circuit's disregard of Liberty's state law rights against its debtor, ET Power, is in direct conflict with the approach adopted by this Court and numerous circuit courts. Accordingly, a grant of certiorari is warranted.

II. This Case Presents a Question of Exceptional Importance Because the Decision Below Creates Substantial Uncertainty as to When Valid State Law Claims Will Be Allowed in Bankruptcy Cases

If the Fourth Circuit's decision is left intact, creditors will be unable to predict when their valid state law claims will be allowed in bankruptcy. This uncertainty inevitably will impair the market for commercial credit — a significant consequence implicating the health of the national economy. This case therefore presents an issue of exceptional importance meriting this Court's review. *See* Sup. Ct. R. 10(a),(c).

In its narrowest application, the decision below undermines the value of guaranties, which are a standard form of credit enhancement in commercial finance. Guaranties help not only lenders, by allowing them to mitigate more effectively the risks of default and insolvency, but borrowers as well. Entities with less than triple A credit ratings may be able to obtain loans only when the lender can procure a guaranty. Similarly, guaranties reduce the cost of credit because they lower the risk of loss. Interest is, of course, an essential component of credit because lenders cannot afford to lend money for no return.

More broadly, the Fourth Circuit's decision casts a cloud over any claim that, despite the absence of misconduct by the creditor, could be perceived as "inequitable" by a federal judge. Here, the Fourth Circuit disallowed Liberty's claim because it (wrongly) believed that doing so would free up funds for other

creditors, which it thought would be a fair result.[7] *But see* App. 17a ("I fail to see the unfairness in the fact that Liberty bargained, outside of bankruptcy, for a guarantee of payment.") (Duncan, J., dissenting); *Mitchell v. Hampel*, 276 U.S. 299, 302 (1928) ("The only real equity is not to disturb the equilibrium established by the parties. Those who take less security have no claim to be put on a footing with those who require more."). If the decision below stands, other creditors with valid state law claims asserted in good faith could similarly be turned away. The resulting uncertainty will drive up the cost of credit, making credit less available. As the Seventh Circuit observed in a case involving equitable subordination, "[i]f a court wrongly subordinates a claim, other investors are sure to take heed. An investor will see that the chance she might not get her money back has gone up slightly. She will be less willing to lend or invest in the future; and the cost of credit will rise for all." *Lifschultz Fast Freight*, 132 F.3d at 347. The Fourth Circuit's rule will turn bankruptcy reorganization into an unpredictable playground, where creditors' recoveries depend on a judge's personal sense of equity instead of on a contractual or other right to payment established by non-bankruptcy law. That is not a fair or efficient system for distributing an insolvent company's assets and liabilities.

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7. The Fourth Circuit was incorrect in this supposition because it failed to account for GTN's rights of indemnity and subrogation. Denying Liberty the $17 million of unpaid principal makes more funds available not to other creditors of ET Power's bankruptcy estate, but to GTN (or its successor in interest), who ultimately can collect by way of indemnity or subrogation the distributions that would have been paid to Liberty. *See* 11 U.S.C. §§ 502(e), 509.

Moreover, the Fourth Circuit's decision leads to absurd consequences. Under the Fourth Circuit's rule, the sequence in which a creditor seeks payment from a debtor and guarantor may dictate the amount of recovery. Here, it is all but certain that had Liberty first recovered from the bankruptcy estate, it then could have proceeded against GTN for any outstanding principal *and interest*. If the bankruptcy estate paid before GTN, no one could argue that Liberty's $140 million claim — the amount of its arbitral award, less interest — represented anything but petition-date damages. Thus, the post-petition interest bar plainly would not apply, and would in no way diminish Liberty's pro rata distributions on its $140 million claim. After those distributions, any unpaid principal and interest could then have been collected from GTN, which was contractually liable for such amounts under the Guaranty. So had Liberty first collected distributions from the bankruptcy estate and only then collected the balance from GTN, it would have recovered the entire debt — principal and interest. However, since GTN made its payment before any distributions were made from the estate, Liberty was denied a full recovery under the lower court's holding. A rule under which the sequence of collection determines the amount of recovery is an absurdity that cannot stand.

CONCLUSION

For the foregoing reasons, this Court should grant the petition for certiorari to the Fourth Circuit.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT DECIDED JULY 10, 2007

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 06-1459

In Re: NATIONAL ENERGY & GAS TRANSMISSION, INCORPORATED, formerly known as PG&E National Energy Group, Inc.,

Debtor.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.),

Plaintiffs-Appellants,

and

GAS TRANSMISSION NORTHWEST CORPORATION,

Plaintiff,

v.

LIBERTY ELECTRIC POWER, LLC,

Defendant-Appellee,

JOHN L. DAUGHERTY, Trustee,

Trustee-Appellee.

Appendix A

Argued: March 13, 2007

Decided: July 10, 2007

OPINION

SHEDD, Circuit Judge.

In this bankruptcy appeal, we must decide whether a creditor may allocate a payment made by a non-debtor guarantor first to interest then to principal, thus preserving the unpaid principal for collection in bankruptcy. Because we find that the allocation of a payment in this manner would permit the creditor to collect an amount otherwise disallowed as post-petition interest, we reverse the judgment of the district court which permitted collection of the additional amount.

I

National Energy & Gas Transmission Energy Trading Power, L.P. ("ET Power"), a debtor here, previously operated as an energy marketing and trading company. As such, it bought and sold electric power, natural gas, coal, and other physical energy commodities. ET Power also engaged in energy-based financial and hedging transactions such as future contracts, swaps, options, and derivatives. As part of its regular course of business, ET Power entered into an electricity tolling agreement (the "Agreement") with Liberty Electric Power, LLC ("Liberty"), an energy-generating company. Under the Agreement, ET Power obtained an option to purchase energy from Liberty in return for a monthly

payment to Liberty as well as certain other variable costs based on the actual amount of energy which ET Power purchased. In essence, this permitted ET Power to provide natural gas necessary to generate electricity and then to purchase the electricity which was generated.

To back up its agreement with ET Power, Liberty obtained two guarantees: one from National Energy & Gas Transmission, Inc. ("NEGT"), ET Power's corporate parent (and also a debtor in this bankruptcy); and one from Gas Transmission Northwest Corporation ("GTN"), a subsidiary of NEGT (and a non-debtor). Each guarantee contained the same terms, and in each the respective guarantor guaranteed:

> [A]s primary obligor and not merely as surety, the prompt payment when due, in accordance with the terms of the Agreement, of all amounts payable by [ET Power] under the Agreement . . . including . . . Termination Payment . . . and damage awards arising by reason of [ET Power's] breach of its performance obligations under the Agreement or otherwise.

J.A. 98. Each guarantor's liability was capped at $140 million.

On July 8, 2003, NEGT, ET Power, and other debtors filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code and a motion seeking to reject the

Agreement.[1] After ET Power and Liberty consented, the bankruptcy court granted the motion rejecting the Agreement. As a result of the rejection, Liberty sought $140 million as a termination payment and approximately $5.4 million in unpaid invoices. Liberty's claim for $140 million proceeded to arbitration pursuant to the terms of the Agreement, and an arbitration panel awarded Liberty the full $140 million plus interest accruing from the date of the Agreement's rejection and continuing subsequent to the arbitration award.[2]

During the pendency of the arbitration proceedings, NEGT agreed to sell GTN to TransCanada Corporation. As part of the transaction, $140 million was reserved in escrow to provide for any liability to Liberty under the guarantee. After the arbitration award, the dispute between Liberty and the debtors shifted back to the bankruptcy court, while interest continued to accrue on the $140 million arbitration award. To stop the accrual of interest, which had reached approximately $17 million, the parties agreed that Liberty should receive immediate

1. As the remaining debtors are not parties to this appeal, we refer herein to NEGT and ET Power as "the debtors." However, we note that the bankruptcy court denied Liberty's claim against NEGT, and Liberty does not appeal this denial.

2. The debtors stipulated to the amounts owed pursuant to the unpaid invoices, and these claims were not submitted to the arbitration panel. Both the bankruptcy court and the district court allowed a claim for these debts in the amount of $5,428,046, and the debtors do not contest this claim on appeal. Thus, in reversing the district court's order, we do not reverse the allowance of this claim.

payment of the amount held in escrow after the GTN sale, and the bankruptcy court approved this disbursal. Accordingly, Liberty was paid $140 million from the GTN sale escrow in full and final satisfaction of the GTN guarantee.

Upon receipt of payment from GTN, Liberty allocated the $140 million first to interest, then to principal. Meanwhile, Liberty continued to assert claims in bankruptcy against NEGT and ET Power for $140 million each.[3] Liberty reasoned that it could continue to assert the full value of the award against the debtors, notwithstanding the fact that it had already received payment of $140 million from GTN, because the debtors remained jointly and severally liable until it received full payment of the total debt. At the same time, Liberty recognized that it could not collect more than the approximately $17 million needed to make it whole on ET Power's debt. In seeking this amount, Liberty contended that the amount did not represent disallowed post-petition interest but rather unpaid principal—the interest portion of the award having been paid by GTN.

3. Liberty set forth ET Power's approximate liabilities as: $140 million in principal, $5.4 million in unpaid invoices, $16.8 million in interest on the principal and invoice amounts, and $3.7 million in collection costs and fees. Liberty recognized that it could not collect the $16.8 million in interest from the debtors, and the invoice amount and collection costs and fees are not at issue in this appeal. For simplicity, we focus on the $140 million at issue here. Likewise, we recognize that Liberty actually seeks to collect approximately $22 million from the estate but that approximately $5 million of this amount (the unpaid invoices) is not at issue. Thus, again for simplicity, we refer herein to the additional $17 million which Liberty seeks and which is now at issue.

The debtors objected to Liberty's claims, arguing that the $17 million which Liberty sought to collect had to constitute post-petition interest because Liberty had already received $140 million from GTN. Additionally, the debtors maintained that Liberty should not be permitted to assert a claim for $140 million when it had received $140 million and currently was owed only an additional $17 million. Otherwise, the judgment would not accurately reflect what Liberty was owed.

The bankruptcy court agreed with Liberty's position, allowing the claim for $140 million against ET Power but providing that the "maximum amount of distribution payable to Liberty" would be limited to the additional $17 million which it seeks to collect. J.A. 322. On appeal to the district court, the bankruptcy court order was affirmed. The debtors once again appeal. Because this appeal presents only questions of law, our review is de novo. *In re Bunker*, 312 F.3d 145, 150 (4th Cir.2002).

II

A.

We initially consider the debtors' contention that the value of Liberty's claim must be reduced by the $140 million it received from GTN in order to reflect accurately the amount currently owed to Liberty. Because Liberty is currently owed only approximately $17 million, the debtors argue its claim should be limited to this amount.

The debtors' argument is foreclosed by the combination of *Ivanhoe Building & Loan Ass'n of Newark v. Orr*, 295 U.S. 243, 55 S.Ct. 685, 79 L.Ed. 1419 (1935), and New York law, which governs pursuant to the Agreement. In *Ivanhoe*, the Supreme Court held that a creditor need not deduct from his claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation. Thus, as a matter of bankruptcy law, ET Power's debt to Liberty is not reduced by the amount which Liberty received from GTN. However, this merely leads to the question of what the value of ET Power's debt is, and New York law provides the answer to this question. *See Travelers Cas. & Sur. Co. of America v. Pacific Gas & Elec. Co.*, __ U.S. __, 127 S.Ct. 1199, 1205, 167 L.Ed.2d 178 (2007) ("[W]e have long recognized that the basic federal rule in bankruptcy is that state law governs the substance of claims [.]") (internal punctuation omitted).

New York law provides:

> The amount or value of any consideration received by the obligee from one or more of several obligors, or from one or more of joint, or of joint and several obligors, in whole or in partial satisfaction of their obligations, shall be credited to the extent of the amount received on the obligations of all co-obligors to whom the obligor or obligors giving the consideration did not stand in the relation of a surety.

N.Y. Gen. Oblig. L. § 15-103. Under this statute, whether GTN's payment to Liberty must be deducted from ET Power's obligation turns on whether GTN was a surety or a co-obligor.

In *Chemical Bank v. Meltzer*, 93 N.Y.2d 296, 690 N.Y.S.2d 489, 712 N.E.2d 656 (1999), the New York Court of Appeals concluded that the relationship between the guarantor and the primary obligor must determine the guarantor's status as a co-obligor or a surety, notwithstanding language in the contract purporting to render the guarantor a co-obligor. Using this approach, the court found that a suretyship existed. The relationship between ET Power and GTN is nearly identical to that of the guarantor and primary obligor in *Meltzer*. Therefore, we conclude that, despite language in the guarantee purporting to make GTN a co-obligor, GTN was a surety for ET Power's obligations to Liberty. Accordingly, the value of ET Power's debt to Liberty under state law is not reduced by the $140 million received from GTN.

B.

We next turn to the more fundamental question presented by this appeal: whether the Bankruptcy Code bars Liberty from collecting the $17 million it now seeks. Section 502(b)(2) of the Code provides that a claim shall not be allowed "to the extent that . . . [it] is for unmatured interest[.]" 11 U.S.C. § 502(b)(2). The purpose of this section is two-fold: (1) the avoidance of unfairness among competing creditors, and (2) the avoidance of

administrative inconvenience. *Bruning v. United States*, 376 U.S. 358, 362, 84 S.Ct. 906, 11 L.Ed.2d 772 (1964). As with all sections of the Code, § 502(b)(2) exists to guide the court in the administration of a bankruptcy estate so "as to bring about a ratable distribution of assets among the bankrupt's creditors." *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 161, 67 S.Ct. 237, 91 L.Ed. 162 (1946); *see also In re A.H. Robins Co., Inc.*, 972 F.2d 77, 82 (4th Cir.1992) (noting that bankruptcy court possesses "broad equity powers"). Indeed, § 502(b)(2) itself reflects the equitable nature of the Code, and our application of its bar on post-petition interest is to be guided by principles of equity. *Vanston Bondholders*, 329 U.S. at 165, 67 S.Ct. 237 ("It is manifest that the touchstone of each decision on allowance of interest in bankruptcy ... has been a balance of equities between creditor and creditor or between creditors and the debtor."). Thus, in applying § 502(b)(2), we have a duty to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." *Smith v. Robinson*, 343 F.2d 793, 801 (4th Cir.1965).[4]

In this case, Liberty seeks to collect $17 million from ET Power notwithstanding the fact that it has already received the full value—$140 million—of the debt which it was owed by ET Power on the petition date. In so doing, Liberty classifies the additional $17 million which

4. The Bankruptcy Code, of course, provides parameters within which courts must exercise their equitable powers in administering an estate. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988).

it seeks as unpaid principal. It reaches this result by applying GTN's payment of $140 million first to interest then to principal. Therefore, Liberty maintains that it is coming into bankruptcy to assert a claim for, and to collect only the remaining portion of, the $140 million which it was owed as of the petition date.

We believe that § 502(b)(2) prevents Liberty from collecting the additional $17 million it seeks despite Liberty's classification of that amount as principal. On the date the debtors filed their bankruptcy petition, the Agreement was effectively rejected and Liberty sustained damages, although the value of the damages was then unknown and disputed. Subsequently, through arbitration, Liberty's damages were determined to be $140 million. Thus, Liberty's damages and ET Power's debt to Liberty on the petition date was $140 million, and by the terms of § 502(b)(2), Liberty could not collect in bankruptcy any additional amounts added due to the accrual of interest. *Nicholas v. United States*, 384 U.S. 678, 682, 86 S.Ct. 1674, 16 L.Ed.2d 853 (1966) ("[T]he accumulation of interest on claims against a bankrupt estate is suspended as of the date the petition in bankruptcy is filed."). This result is not altered simply because Liberty holds a guarantee from a non-debtor third party. Accordingly, the arbitration panel's award of interest on the $140 million in damages, while perhaps appropriate under the Agreement and as a matter of non-bankruptcy law, is not collectable from the debtors in bankruptcy by virtue of § 502(b)(2).

Appendix A

The § 502(b)(2) bar to collection of interest is not overcome by Liberty's classification of the $17 million it now seeks as principal. Regardless of how Liberty classifies GTN's payment for its own purposes, we must "sift the circumstances surrounding" the claim to determine the reality of the transaction for purposes of the bankruptcy proceeding. *Smith*, 343 F.2d at 801. Because ET Power's debt was capped at $140 million by the filing of the bankruptcy petition and because the debt was increased only by the accrual of interest pursuant to the arbitration award, we view Liberty's claim for an additional $17 million as disallowed post-petition interest no matter how Liberty chooses to classify it.[5]

A contrary result would permit Liberty, or any other creditor, to classify a payment on a debt from a non-debtor guarantor as non-principal, thus preserving the

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5. Liberty claims that we must accept its classification of GTN's payment as interest rather than as principal because bankruptcy proceedings cannot affect the liability of a non-debtor on a debt. *See, e.g., In re Stoller's, Inc.*, 93 B.R. 628, 635-36 (Bankr.N.D.Ind.1988) (finding that guarantors remained liable for post-petition interest as allowed by terms of guarantee). Thus, Liberty argues that preventing it from collecting the additional $17 million it seeks will essentially relieve GTN of its obligation to pay interest. We disagree. Liberty is free to classify GTN's payment as interest or to pursue collection from GTN at any time. Any limitation of Liberty's right to recover from GTN the full amount it is owed is due to the terms of GTN's guarantee or to non-bankruptcy law, not to our decision here. We merely hold that Liberty may not affect the rights of a party in bankruptcy by its classification of a payment received from a non-debtor guarantor.

full value of the principal for collection in bankruptcy. If, for example, Liberty had classified GTN's payment of $140 million not as a payment on the debt but as consideration received in return for a covenant not to sue, we would certainly look behind the transaction and would not allow collection as principal of the full $140 million. We must likewise look behind Liberty's claim here to find that the claim really constitutes post-petition interest disguised as unpaid principal.

Our construction of Liberty's claim is reinforced by the policy interests represented by § 502(b)(2). As we noted earlier, the general purpose of § 502 is "to ensure the fair allocation of assets between creditors[.]" *In re Kielisch*, 258 F.3d 315, 325 (4th Cir.2001). Thus, in cases where the allowance of post-petition interest will not result in administrative inconvenience or unfairness to creditors, post-petition interest may be allowed. *See, e.g., United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 246, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989) (noting pre-Bankruptcy Code rule permitting the award of post-petition interest where estate is solvent); *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860, 869 (4th Cir.1994) (referring to rule permitting an over-secured creditor to collect interest to the extent of his over-security). In contrast, allowing Liberty to collect the additional amount it seeks *will* have an impact on ET Power's creditors: namely, the loss of $17 million from the estate which would otherwise be available for distribution. This being so, the purpose of § 502(b)(2) is best served by barring Liberty's collection of an additional $17 million from the estate.

III

For these reasons, we conclude that § 502(b)(2) prevents Liberty from collecting the additional $17 million which it seeks from the estate. Accordingly, we reverse the judgment of the district court and remand for further proceedings consistent with this opinion. In so doing, we do not reverse the allowance of Liberty's claim for unpaid invoices, which is not before us in this appeal.

REVERSED

WILSON, District Judge, concurring in the judgment:

As I view it, the overarching issue in this appeal is reduced to this: does Liberty's contractual right with GTN, a third party, to allocate principal and interest, that is, to call payments from that guarantor what it wants to call them, preclude the Bankruptcy Court from calling those payments what they are vis-à-vis the bankrupt debtor. That is, can Liberty allocate its way around § 502(b)(2)'s disallowance of unmatured interest. In my view to do so is to simply call a rose by another name.* Accordingly, I concur in the judgment.

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* Two preliminary observations simplify the playing field for me. First, I do not believe that Judge Shedd's opinion challenges Liberty's contractual rights under its guarantee from GTN to allocate principal and interest in any fashion it sees fit in relation to GTN. Second, we are not compelled to explore Liberty's right to recover from NEGT under NEGT's guarantee

(Cont'd)

Appendix A

DUNCAN, Circuit Judge, dissenting:

As the bankruptcy court succinctly stated in an order summarily affirmed by the district court, the debtors here proffer no authority "for the proposition that a *non-debtor* guarantor is exempt from liability to pay interest accruing after the petition date of the debtor-primary obligor" under 11 U.S.C. § 502(b)(2). *Nat'l Energy & Gas Transmission, Inc. v. Liberty Elec. Power, LLC (In re Nat'l Energy & Gas Transmission, Inc.)*, No. 03-03104, at *6 (Bankr.D. Md. June 27, 2005) (emphasis added). Because the majority advances no support for its conclusion that bankruptcy law governs the contractual relationship between a creditor and a non-debtor guarantor—and ample authority exists to the contrary—I respectfully dissent.

As the majority explains, an arbitration panel awarded Liberty $140 million plus approximately $17 million in interest accrued after the debtors' bankruptcy petition had been filed. Liberty collected $140 million from GTN, which was the maximum amount for which GTN could be liable under the terms of its guarantee. Liberty characterized GTN's payment as first, a payment of the $17 million interest, and next, a payment of part of the $140 million principal.

(Cont'd)

because the Bankruptcy Court disallowed Liberty's claim against NEGT and Liberty did not appeal. Indeed, at the risk of oversimplification, NEGT seems to be little more than a cheerleader for ET Power or a surrogate for GTN in this appeal. The real dispute, therefore, is only between the primary obligor and its creditor.

Liberty continued to assert its claim in bankruptcy against the debtors for the full $140 million, recognizing, however, that it could not collect more than the approximately $17 million needed to satisfy the debt. In Liberty's view, this $17 million represented principal for which the debtors remained jointly and severally liable, even though they had filed for bankruptcy. [1]

Proper analysis of Liberty's claim begins with the basic principle of contract law that Liberty is entitled to be paid in full, including interest, by its jointly and severally liable debtors. When one or more debtors file a bankruptcy petition, as here, it is undisputable that § 502(b)(2) bars a creditor from recovering interest not yet accrued as of the date of the bankruptcy petition against such a debtor. *See* Majority Op. at 301-03. However, it is also well-settled that § 502(b)(2) has no impact on the accrual of unmatured interest against non-debtors, including non-debtor guarantors. *See, e.g., Bruning v. United States*, 376 U.S. 358, 362 n. 4, 84 S.Ct. 906, 11 L.Ed.2d 772 (1964) (explaining that claims do not "los[e] their interest-bearing quality" in bankruptcy, but that post-petition interest is disallowed as a "rule of distribution"); *Kielisch v. Educ. Credit Mgmt Corp. (In re Kielisch)*, 258 F.3d 315, 323 (4th Cir.2001) ("Section 502 bars creditors from making *claims* from the bankruptcy estate for unmatured interest," but "does not purport to limit the *liability* on those claims, i.e., 'debts.' "); *In re El Paso Refining, Inc.*, 192 B.R. 144, 146 (Bankr.W.D.Tex.1996) (holding that § 502(b)(2) only

1. As the majority notes, only Liberty's claim against ET Power is at issue in this appeal.

bars "unmatured interest from becoming an allowed claim against the debtor's [bankruptcy] estate" and that "the obligation to pay interest vis-a-vis a guarantor is not tolled or eliminated by operation of section 502(b)(2)" (emphasis omitted)).

The majority intermingles these independent principles to arrive at its holding: that the $17 million that Liberty seeks to recover from ET Power represents "disallowed post-petition interest no matter how Liberty chooses to classify it." Majority Op. at 302. This approach, however, has the effect of limiting the non-debtor guarantor's liability for interest accruing after the debtor's bankruptcy petition. That is, the majority would have the bar to recovery of interest from the debtor swallow the accrual of interest on the debt across all parties liable for it. There is simply nothing in the Bankruptcy Code, applicable case law, the relevant guarantee agreement, or nonbankruptcy law to support the jettisoning of basic contract law principles in favor of an expansive reading of § 502(b)(2).[2]

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2. The majority attempts to justify its result by invoking this court's duty to " 'sift the circumstances surrounding' the claim to determine the reality of the transaction for purposes of the bankruptcy proceeding." Majority Op. at 302 (citing *Smith v. Robinson*, 343 F.2d 793, 801 (4th Cir.1965)). There is no reason, however, to allow "sift[ing] the circumstances" to engulf even basic principles of contract law by restructuring the private contracts of non-debtors.

The majority also seeks to place the blame for Liberty's inability to collect the full amount of its debt on the guarantee

(Cont'd)

In fact, the majority's approach actually seems to run counter to another section of the Bankruptcy Code. Section 524(e) provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." *See also El Paso*, 192 B.R. at 146 (holding that § 524(e) mandated that the independent obligations of a guarantor were unaffected by the bankruptcy of the principal obligor); *Stoller's, Inc. v. Peoples Trust Bank (In re Stoller's, Inc.)*, 93 B.R. 628, 635-36 (Bankr.N.D. Ind.1998) (holding guarantors liable for post-petition interest). The majority's holding appears to expressly violate § 524(e) by allowing the bankruptcy filing of the debtors to dictate how Liberty accounts for its contractual payment from GTN, or, in other words, allowing the "discharge of a debt of the debtor [to] affect the liability of [GTN] on . . . such debt," § 524(e).

Furthermore, in contrast to the majority's contention, I do not believe that a creditor's receipt of payment from a non-debtor guarantor implicates either of the purposes of § 502(b)(2): (1) avoiding "unfairness as between competing creditors" and (2) minimizing the

---

(Cont'd)

itself, which caps GTN's liability at $140 million. *See id.* at 303 n. 5. If GTN's liability under the guarantee were unlimited, the majority apparently reasons, Liberty could collect the full value of its claim from GTN. As a matter of contract law, the majority is correct. But, as the bankruptcy court noted, "the cap [on GTN's liability in its contract with Liberty is] no impediment to Liberty's right to be paid in full from all sources" where the debtors are jointly and severally liable for the principal debt. *Nat'l Energy & Gas Transmission, Inc.*, No. 03-03104, at *8.

"administrative inconvenience" that repeated recomputation of interest requires, *Bruning*, 376 U.S. at 362, 84 S.Ct. 906. With respect to the first, I fail to see the unfairness in the fact that Liberty bargained, outside of bankruptcy, for a guarantee of payment. That other creditors may not have secured such a guarantee, and therefore might ultimately recover proportionally less than Liberty, strikes me as no injustice. Second, even the debtors do not argue that the bankruptcy court's order below would require burdensome recomputation of interest, as it specifies the allowed amount of Liberty's claim as determined in the arbitration proceeding.

Therefore, because neither bankruptcy law nor the contract governing Liberty's relationship with the non-debtor guarantor GTN limits Liberty's right to allocate its recovery from GTN in any manner that it wishes, I would affirm the district court.

APPENDIX B — FINAL ORDER OF JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND FILED MARCH 7, 2006

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

Civil No. PJM 05-2531

In re:

NATIONAL ENERGY &
GAS TRANSMISSION, INC., et al.,

Debtors.

NATIONAL ENERGY &
GAS TRANSMISSION, INC., et al.,

Plaintiffs,

v.

LIBERTY ELECTRIC POWER, LLC,

Defendant.

FINAL ORDER OF JUDGMENT

Upon consideration of National Energy & Gas Transmission, Inc., et al.'s Appeal of the Bankruptcy Court's Order of August 10, 2005 Granting 1) Motion to Confirm an Arbitration Award, and 2) Motion to Dismiss

Appendix B

Adversary Proceeding and Objection to Claims and for Related Relief; and Liberty Electric Power, LLC's Opposition thereto; it is for the reasons stated on the record this 6th day of March, 2006

ORDERED:

1) The Bankruptcy Court's Order of August 10, 2005 Granting 1) Motion to Confirm an Arbitration Award, and 2) Motion to Dismiss Adversary Proceeding and Objection to Claims and for Related Relief is AFFIRMED; and

2) The Clerk of Court SHALL CLOSE this case.

/s/
PETER J. MESSITTE
UNITED STATES DISTRICT JUDGE

APPENDIX C — ORDER OF THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF MARYLAND, GREENBELT DIVISION FILED AUGUST 10, 2005

IN THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF MARYLAND (Greenbelt Division)

Case No.: 03-30459 (PM) and 03-30461 (PM) through 03-30464 (PM)
Chapter 11
(Jointly Administered under Case No.: 03-30459 (PM))

Adversary Proceeding No.: 03-03104

In re:

NATIONAL ENERGY & GAS TRANSMISSION (f/k/a PG&E NATIONAL ENERGY GROUP, INC.), et al.,

Debtors.

NATIONAL ENERGY & GAS TRANSMISSION (f/k/a PG&E NATIONAL ENERGY GROUP, INC.), NEGT ENERGY TRADING L.P. (f/k/a PG&E ENERGY TRADING - POWER, L.P.), and GAS TRANSMISSION NORTHWEST CORPORATION,

Plaintiffs,

v.

LIBERTY ELECTRIC POWER, LLC,

Defendant.

Appendix C

ORDER GRANTING (I) MOTION TO CONFIRM AN ARBITRATION AWARD, AND (II) MOTION TO DISMISS ADVERSARY PROCEEDING AND OBJECTION TO CLAIMS AND FOR RELATED RELIEF

Upon consideration of: (i) the motion of Liberty Electric Power, LLC ("Liberty") for entry of an order confirming an arbitration award (the "Confirmation Motion"), and (ii) Liberty's motion for entry of an order dismissing with prejudice the above-captioned adversary proceeding (the "Adversary Proceeding") and the Debtors' Objection to Allowance of Claims Nos. 323 and 325 Filed by Liberty Electric Power, LLC (the "Claim Objection") and seeking related relief (the "Dismissal Motion" and together with the Confirmation Motion, the "Motions"),[1] and upon consideration of the objection filed by the Debtors and the other pleadings and papers of record herein, adequate and proper notice of the Motions having been given, and upon the record of the hearing held on May 12, 2005 and this court's Memorandum of Decision dated June 24, 2005, and for good cause shown, it is by the United States Bankruptcy Court for the District of Maryland, sitting in Greenbelt,

ORDERED, ADJUDGED AND DECREED as follows:

1. The Motions are granted and approved to the extent set forth herein.

---

1. Capitalized terms not otherwise defined herein have the meanings ascribed to them in the Motions.

2. The Award, a copy of which is annexed hereto as Exhibit A, is hereby confirmed.

3. The Clerk of the Court is directed to enter judgment confirming the Award against NEGT Energy Trading-Power, L.P. (f/k/a PG&E Energy Trading-Power, L.P.) ("ET Power") in the amount of $162,725,436.59 (the "Judgment Amount").[2]

4. The Adversary Proceeding is hereby dismissed with prejudice.

5. Claim number 323 filed by Liberty in the chapter 11 case of ET Power is hereby allowed as a general unsecured claim in the ET Power case in the amount of $145,428,046 (the "Allowed Claim"); *provided*, that the maximum amount of distribution payable to Liberty on account of the Allowed Claim shall be $22,725,436.59 (*i.e.*, the Judgment Amount less the $140 million payment from the GTN Escrow).

6. Liberty's claims for costs and legal fees are denied.

7. Claim number 325 filed by Liberty in the chapter 11 case of NEGT shall be expunged without further order of the Court. The Court-appointed claims agent for the Debtors is directed to amend the official claims register to reflect the expungement of such claim.

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2. The Judgment Amount represents the aggregate of the principal amounts of the Award, the June Invoice and the July Invoice, plus accrued interest through the date of payment from the GTN Escrow.

8. This Court shall retain jurisdiction over all claims and matters between the Debtors and Liberty, including the matters contained in this Order.

END OF ORDER

APPENDIX D — MEMORANDUM OF DECISION OF THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF MARYLAND AT GREENBELT DATE SIGNED JUNE 24, 2005

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND
at Greenbelt

Case Nos. 03-30459PM; 03-30461PM
through 03-30464PM

Chapter 11

Jointly Administered under Case No. 03-30459PM

Adversary Proc. No. 03-03104

In re:

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E NATIONAL ENERGY GROUP, INC.), *et al.*,

Debtors.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E NATIONAL ENERGY GROUP, INC.); NEGT ENERGY TRADING POWER - L.P. (f/k/a PG&E ENERGY TRADING - POWER, L.P.; and GAS TRANSMISSION NORTHWEST CORPORATION,

Plaintiffs,

v.

LIBERTY ELECTRIC POWER, LLC,

Defendant.

Appendix D

MEMORANDUM OF DECISION

Before the court are two motions of the defendant Liberty Electric Power, LLC ("Liberty"), a "Motion to Confirm an Arbitration Award" and a "Motion to Dismiss Adversary Proceeding and Objection to Claims, and for Related Relief" and the opposition thereto. This court has jurisdiction of this matter pursuant to 28 U.S.C. § 1334(a), 28 U.S.C. § 157(a) and Local Rule 402 of the United States District Court for the District of Maryland, referring all cases under Title 11 of the United States Code to the Bankruptcy Judges of this District. This is a core proceeding under 28 U.S.C. § 157(b)(2)(A) and (O).

Background

In April 2000, Liberty and NEGT Energy Trading-Power, L.P. (f/k/a PG&E Energy Trading-Power, L.P.) ("ET Power") entered into a Tolling Agreement that granted, among other things, ET Power first access to production capacity of Liberty's electric power generating facility. PG&E Gas Transmission, Northwest Corporation ("GTN") guaranteed ET Power's obligations in February, 2001. The guarantee was capped at $150,000,000 and later reduced to $140,000,000.

ET Power allegedly defaulted under the Tolling Agreement, resulting in unpaid invoices for June and July, 2003, totaling $5,428,045.82. On July 8, 2003, ET Power filed a bankruptcy case under chapter 11. ET Power's rejection of the Tolling Agreement was approved

by this court by order dated August 6, 2003 (amended by order dated August 11, 2003). The rejection resulted in a breach of the Tolling Agreement. Liberty sought payment of the unpaid invoices and a "Termination Payment" pursuant to § 14.2(a) of the Tolling Agreement from ET Power. Liberty also sought payment from GTN, the non-debtor guarantor.

When GTN did not honor the guarantee, Liberty filed an action in the United States District Court for the Southern District of Texas. Liberty also filed Proofs of Claim in both the ET Power and National Energy & Gas Transmission, Inc. (f/k/a PG&E National Energy Group, Inc.) ("NEGT") cases.[1] The claims were objected to by each debtor.

In September, 2003, plaintiffs commenced this adversary proceeding. Ultimately, the action against GTN was stayed and the dispute was arbitrated, resulting in an award in Liberty's favor and against ET Power.[2] In the arbitration proceeding, Liberty sought compensation for the Termination Payment, the unpaid invoice amounts, costs and fees and interest. The panel found that Liberty

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1. Liberty asserted a general unsecured claim against ET Power in the amount of $182,198,749.90, plus additional amounts, and a general unsecured claim against NEGT in the amount of $140,000,000.

2. The arbitration proceeding was before the American Arbitration Association in the *Matter of Liberty Electric Power, LLC, Claimant, v. NEGT Electric Trading - Power, L.P., Respondent*, Case No. 70 198 Y 00228 04.

was entitled to a $140,000,000 Termination Payment, plus interest accruing from July 8, 2003, the stipulated date of breach. The panel declined to rule upon the accrual of interest on the unpaid and undisputed invoice amounts and concluded that each party was to bear its own costs.

Discussion

The arbitration award will be confirmed by this court in accordance with § 9 of the Federal Arbitration Act (9 U.S.C. § 1 *et. seq.*). Plaintiffs do not object to the entry of an order confirming the panel's award of $140,000,000. The court is informed that, in accordance with an order entered May 18, 2005, $140,000,000 was wired to Liberty on May 19, 2005, in full and final satisfaction of the GTN Guarantee.[3] However, there remains disputed issues for decision that do not involve confirmation of the award but ultimately affect the amounts of the judgment to be entered and the resolution of the contested matter.

(1) The Parties' Positions.

Liberty asserts that GTN is liable for *all* of the ET Power-guaranteed obligations under the Tolling Agreement, including costs and fees and interest, subject

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3. In May, 2004, NEGT sold 100% of the GTN stock to TransCanada Corporation. The sale agreement required that a sum equal to the full amount of the GTN Guarantee be placed in an escrow account. Pursuant to the agreements executed at the time of sale, any liability of GTN to Liberty would be paid from this escrow.

to the $140,000,000 cap.[4] Liberty further contends that it may simultaneously assert claims against ET Power and NEGT, without any reduction for payment, until paid in full. It argues that it may apply the payment from GTN first to interest, then to costs and fees and lastly to principal and that plaintiffs do not have standing to direct application.

Plaintiffs' position is murkier but boils down to Liberty is entitled to *only* the payment of the Termination Payment and the unpaid invoice amounts. As to the undisputed invoice amounts, plaintiffs consented to the allowance of Liberty's claims (excluding interest) against NEGT and ET Power but, in a later responsive pleading, by footnote, reversed this position as to NEGT. As to the arbitration award, they take the position that since Liberty has been paid the $140,000,000 Termination Payment, there exists no further liability as to NEGT or ET Power – no postpetition interest owed pursuant to 11 U.S.C. § 502(b)(2) despite the arbitration panels' award and no chargeable costs and fees. Plaintiffs argue that once the amount of the GTN Guarantee cap has been paid, no further funds can be charged to GTN or, by virtue of the

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4. Liberty sets forth ET Power's approximate liabilities as:

Principal - $140,000,000
Invoices - $5,400,000
Interest (on the Termination Payment and the unpaid invoice) - $16,800,000 Collection costs/fees - $3,700,000

NEGT Guarantee[5], to NEGT. Plaintiffs posit further assent that Liberty must apply the $140,000,000 guarantee payment first to principal.

(2) Postpetition Interest.

Liberty seeks $16,181,086 in interest from July 8, 2003 to March 30, 2005, on the Termination Payment, together with interest accruing at $33,162.00 per day. It also seeks $6,027,273 in interest through March 30, 2005, on the unpaid invoiced amounts, interest accruing at $238 per day. Whether Liberty is entitled to collect this interest from plaintiffs involves the interpretation of paragraphs 1 and 2 of the GTN Guarantee. Paragraphs 1 and 2 of the Guarantee state:

> 1. *Guarantee.* Subject the terms herein, the GTN Guarantor absolutely, unconditionally and irrevocably guarantees to the Guaranteed Party, its successors and assigns, as primary obligor and not merely as surety, the prompt payment when due, in accordance with the terms of the Agreement, of all amounts payable by

5. Plaintiffs assert that there is no basis for any claim against NEGT, citing to the NEGT Guarantee. NEGT's liability arose from its Guarantee, dated February 6, 2001. Plaintiffs argue that, pursuant to paragraph 2, NEGT's liability is reduced by any amounts paid by GTN under the GTN Guarantee – *i.e.*, once the $140,000,000 is paid by GTN, no further liability exists. Liberty asserts that pursuant to section 7 of the NEGT Guarantee, it may make a demand on NEGT for any obligations that remain unpaid, subject to the cap.

Affiliate under the Agreement and any amendments thereto, including without limitation, Tolling Fees, Termination Payment, liquidated damages, indemnity obligations, and damage awards arising by reason of Affiliate's breach of its performance obligations under the Agreement or otherwise (collectively, the "*Obligations*"). The obligation to make payments under this Guarantee is a guarantee of payment and not of collection. If Affiliate fails to pay any Obligation, GTN Guarantor will pay such Obligation directly for Guaranteed Party's benefit on the terms and subject to the conditions set forth in Section 7. Capitalized terms used and not defined herein shall have meaning given such terms in the Agreement.

2. *Extent of Liability & Term.* GTN Guarantor's liability under this Guarantee is limited to the aggregate of US$150,000,000, as reduced (I) pursuant to Section 8.1(b) of the Agreement and (ii) by any amounts paid by the NEG Guarantor pursuant to the NEG Guarantee and not returned to the NEG Guarantor by or on behalf of the Guaranteed Party (the "*Guarantee Cap*"). GTN Guarantor shall not be obligated to monitor the amount of Affiliate's Obligations to Guaranteed Party, and Guaranteed Party will bear the risk that the aggregate amount

> of the Obligations exceeds the Guarantee Cap and only payments made by GTN Guarantor pursuant to a demand for payment in accordance with Section 7 hereof shall reduce the amount of the Guarantee Cap. No payments will be made hereunder unless and until a Payment Demand has been issued by the Guaranteed Party in accordance with Section 7 hereof. Except as the same comprise Obligations under the Agreement, GTN Guarantor shall not be liable hereunder for special, consequential, exemplary, tort or other damages. GTN Guarantor agrees to pay all out-of-pocket expenses (including the reasonable fees and expenses of Guaranteed Party's counsel) incurred for the enforcement of the rights of Guaranteed Party hereunder; provided that GTN Guarantor shall not be liable for any such expenses if no payment under this Guarantee is due and such payments shall be subject to the Guarantee Cap.

Paragraph 1 of the GTN Guarantee provides Liberty with assurance that if ET Power fails to pay for any "Obligations" due under the Tolling Agreement, GTN will pay. These "Obligations" include interest under Section 14.2(a) of the Tolling Agreement. The GTN Guarantee merely limits GTN's liability to $140,000,000. It does not limit ET Power's liability under the Tolling Agreement. ET Power and NEGT (derivatively by virtue of its Guarantee) are liable to Liberty for interest.

Plaintiffs argue, nonetheless, that as an unsecured creditor, Liberty is not entitled to postpetition interest on its claims against ET Power and NEGT pursuant to 11 U.S.C. § 502(b)(2). Plaintiffs also allege that interest cannot be charged to GTN because the GTN Guarantee does not provide for interest – thereby limiting the liability of all parties to the $140,000,000 paid by GTN.

Liberty argues that GTN's obligation to pay interest is not tolled or eliminated by the application of 11 U.S.C. § 502(b)(2), asserting that its claim against a third party does not lose its interest-bearing quality during the postpetition period. Liberty maintains that application of 11 U.S.C. § 502(b)(2) would, in essence, grant the non-debtor GTN a discharge contrary to 11 U.S.C. § 524(e).

The court believes that the issue is one of novel impression and would be an ideal case for certification to the United States Court of Appeals for the Fourth Circuit pursuant to the revisions to 28 U.S.C. § 158(d)(2) made by § 1233 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (effective October 17, 2005). Nonetheless, 11 U.S.C. § 502(b)(2) provides:

> (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim as of the date of the filing of the petition, and shall allow such claim in lawful currency of the United States in such amount, except to the extent that–

> (2) such claim is for unmatured interest.

Plaintiffs cite no authority for the proposition that a non-debtor guarantor is exempt from liability to pay interest accruing after the petition date of the debtor-primary obligor. They rely on what they term as an "analytically identical body of law" addressing recoveries on claims limited by 11 U.S.C. § 502(b)(6) and, by analogy, on the opinions of three courts.[6]

The court finds the analogy inappropriate. The limitation of 11 U.S.C. § 506(b)(6) on the amount that a landlord may recover on account of a rejected lease has long been a part of bankruptcy jurisprudence.

As noted in the Legislative History of the Bankruptcy Reform Act of 1978, this section is:

> [d]erived from current law, limits the damages allowable to a landlord of the debtor. The history of this provision is set out at length in *Oldden v. Tonto Realty Co.*, 143 F.3d 916 (CA2 1944). It is designed to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as

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6. *Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 209 (CA3 2003); *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 300 (BAP CA9 2004); *see also SBTI Liquidating Trust v. EOP-Colonnade of Dallas, LP (In re Stonebridge Tech. Inc.)*, 291 B.R. 63, 70-72 (BC N.D. Tex. 2003).

to prevent other general unsecured creditors from recovering a dividend from the estate. The damages a landlord may assert from termination of a lease are limited to the rent reserved for the greater of one year or ten percent of the remaining lease term, not to exceed three years, after the earlier of the date of the filing of the petition and the date of surrender or repossession in a chapter 7 case and 3 years least payments in a chapter 9, 11, or 13 case. The sliding scale formula for chapter 7 cases is new and designed to protect the long-term lessor. This subsection does not apply to limit administrative expense claims for use of the leased premises to which the landlord is otherwise entitled.

This paragraph will not overrule *Oldden*, or the proposition for which it has been read to stand: to the extent that a landlord has a security deposit in excess of the amount of his claim allowed under this paragraph, the excess comes into the estate. Moreover, his allowed claim is for his total damages, as limited by this paragraph. By virtue of proposed 11 U.S.C. § 506(a) and § 506(d), the claim will be divided into a secured portion and an unsecured portion in those cases in which the deposit that the landlord holds is less than his damages. As under *Oldden*, he will not be permitted to offset his actual damages against his security deposit and then claim for the

> balance under this paragraph. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under this paragraph.

S.Rep. 95-989, 63-64 (1978). However, 11 U.S.C. § 502(b)(2) is based upon entirely different reasoning. As Justice Black explains in *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 163-64 (1946), allowing interest would create a nightmare of continuous recomputation that is avoided by § 502(b)(2). *See In re Fesco Plastics Corp., Inc.*, 996 F.2d 152, 155 (CA7 1993).

The court finds that the *Oldden* doctrine carried into the Bankruptcy Reform Act of 1978 by § 506(b)(7), now § 506(b)(6), is not relevant to the current situation. The rationale of § 506(b)(6) found in most situations has no application here. The guarantee of GTN does not function as a security deposit and thus provide an "endrun" around § 502(b)(2) as described in *PPI Enterprises, Inc.*, 324 F.3d at 209 (No collateral of either NEGT or ET Power secures GTN. The payment of interest by GTN does not diminish this estate). The capping of recovery and application of security deposits for landlords is *sui generis*.[7]

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7. The court is astounded that the International Council of Shopping Centers, perhaps Washington's most potent lobbyist on bankruptcy issues, was not able to improve its situation as to allow its absorption of security deposits, as it improved its position with respect to 11 U.S.C. § 365(d)(4) in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Here, the claim of Liberty against GTN, a jointly and severally liable non-debtor, suffers no limitation as that posited by Justice Black. GTN's obligation is to pay no more than the $140,000,000 cap. The court finds the cap no impediment to Liberty's right to be paid in full from all sources.

(3) Liberty's Costs and Fees.

Liberty seeks its fees and costs in connection with this action, totaling $3,656,113.06 through February, 2005. Plaintiffs' argue that Liberty incurred costs in enforcing the Tolling Agreement and not the GTN Guarantee and that the GTN Guarantee allows costs only for expenses incurred for the enforcement of the GTN Guarantee. Further, plaintiffs note that the arbitration panel specifically held that each party to the Tolling Agreement shall bear their own costs. The court finds that the costs and fees incurred by Liberty were not in enforcing the GTN Guarantee, but in enforcing the Tolling Agreement. Accordingly, Liberty is not entitled to its costs and fees.

(4) Plaintiffs' Standing to Direct Application of Payments Under the GTN Guaranty.

This court holds that, absent an agreement to the contrary, Liberty may apply the funds in a manner that it finds commercially reasonable.

Counsel for Liberty is directed to submit an appropriate order confirming the arbitration award and dismissing this adversary proceeding, an appropriate judgment and an appropriate order dispensing of the contested matter consistent with this Memorandum.

APPENDIX E — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT DENYING PETITION FOR REHEARING FILED AUGUST 6, 2007

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 06-1459
8:05-CV-02531-PJM
03-30459
AP 03-03104

In Re: NATIONAL ENERGY & GAS TRANSMISSION, INCORPORATED, formerly known as PG&E National Energy Group LLC

Debtor

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT ENERGY TRADING POWER, L.P., (f/k/a PG&E Energy Trading Power, L.P.)

Plaintiffs - Appellants

and

GAS TRANSMISSION NORTHWEST CORPORATION

Plaintiff

v.

LIBERTY ELECTRIC POWER, LLC;

Defendant - Appellee

JOHN L. DAUGHERTY, Trustee

Trustee - Appellee

Appendix E

On Petition for Rehearing and Rehearing En Banc

Appellees filed a petition for rehearing and rehearing en banc.

Judge Duncan voted to grant panel rehearing. Judges Shedd and Wilson voted to deny.

No member of the Court requested a poll on the petition for rehearing en banc.

The Court denies the petition for rehearing and rehearing en banc.

Entered at the direction of Judge Shedd for the Court.

For the Court,
/s/ Patricia S. Connor
CLERK

FILED
JAN 2 5 2008
OFFICE OF THE CLERK
SUPREME COURT, U.S.

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(3)

No. 07-684

IN THE

Supreme Court of the United States

LIBERTY ELECTRIC POWER, LLC,

Petitioner,

v.

NATIONAL ENERGY & GAS TRANSMISSION, INC. and NEGT ENERGY TRADING POWER, L.P.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether a creditor of a chapter 11 debtor can defeat Congress's proscription against allowance of claims for unmatured interest, expressly stated in the plain text section 502(b)(2) of the Bankruptcy Code, by allocating a payment from a non-debtor guarantor first to interest, then to principal, and then characterizing its claim as a claim for principal in order to collect against a bankrupt primary obligor.

CORPORATE DISCLOSURE STATEMENT

Respondent National Energy & Gas Transmission, Inc. (f/k/a PG&E National Energy Group) has no parent, is not a publicly held corporation, and no publicly held entity owns 10% or more of its stock.

Respondent NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.) has no parent, is not a publicly held corporation, and no publicly held entity owns 10% or more of its stock.

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PRELIMINARY STATEMENT

This matter arises from the chapter 11 bankruptcy cases of respondents National Energy & Gas Transmission, Inc. ("NEGT") and NEGT Energy Trading Power, L.P. ("ET Power") and others (collectively, the "Debtors"). Petitioner Liberty Electric Power LLC ("Liberty") sought to recover from the Debtors' estates money it claimed to be owed in connection with an arbitration award ("Award") obtained after the bankruptcy was filed and after Liberty collected the full principal amount of the Award from ET Power's non-debtor guarantor. In the decision below, a majority of a Fourth Circuit panel recognized that, although Liberty characterized its general unsecured claim against ET Power as one for principal, Liberty's claim was actually an unsecured claim for unmatured interest (*i.e.*, interest accrued after the bankruptcy petition was filed), which the plain text of section 502(b)(2) of the Bankruptcy Code expressly disallows. 11 U.S.C. § 502(b)(2).

There is no warrant for certiorari review of the decision below. First, there is no circuit split on the only issue presented here – whether section 502(b)(2) bars Liberty's unsecured claim for unmatured interest, notwithstanding Liberty's characterization of the claim as one for principal. No other circuit court has decided the issue in this context, much less issued a conflicting decision. The majority's analysis fully comports with that routinely applied by other courts in considering whether an unsecured claim is one for unmatured interest that must be disallowed under section 502(b)(2), and Liberty cites nothing to the

contrary. The majority's analysis is also consistent with and supported by decisions construing other Bankruptcy Code provisions; in particular, decisions applying the analogous section 502(b)(6).

There also is no conflict with any of the Court's precedents concerning the relationship between state law and federal bankruptcy law. It is settled that federal law governs the question whether to allow interest on claims against a debtor's estate. So too, the majority's section 502(b)(2) analysis is entirely consistent with this Court's precedents concerning the proper construction of Bankruptcy Code provisions – *i.e.*, according to the statute's plain text and with due regard for the fundamental policies served by the statute and the Code, as well as the statute's history and relationship to other Code provisions.

Given that no other circuit court has addressed the question decided below, and the absence of a conflict with any decision of this Court, further development of the issue in the lower courts is warranted and certiorari review is premature.

Critically, the circuit split alleged by Liberty concerns a purported disagreement among the lower courts concerning *completely different questions* from the one presented here – application of section 510(c) of the Bankruptcy Code and issues of equitable subordination and disallowance. These issues are irrelevant to the question decided by the Fourth Circuit, and were neither briefed nor decided below. To the extent it applied equitable principles in denying Liberty's claim for unmatured interest, the majority correctly did so, consistent with the decisions of other

circuit courts and this Court, to enforce section 502(b)(2)'s intent and plain meaning.

Finally, the decision below presents no issue of extraordinary public importance warranting this Court's intervention. There is no basis for the allegations of Liberty and its *Amicus* concerning, *inter alia*, the purported catastrophic effects of the decision on commercial expectations and the credit markets. The majority expressly confirmed Liberty's state-law rights; there can be no dispute that payment of Liberty's claim would have reduced the funds available for distribution to other creditors; and the only parties affected by the decision are the parties to this case and the Debtors' other creditors.

The Court should deny Liberty's petition.

STATEMENT OF THE CASE

A. Background

In April 2000, Liberty entered into an agreement ("Agreement") with ET Power that gave ET Power the right to purchase energy from Liberty in exchange for a monthly capacity payment. Pet. App. 2a-3a, 26a. Liberty procured limited guarantees of payment from NEGT, an indirect parent of ET Power, and Gas Transmission Northwest Corporation ("GTN"), an NEGT subsidiary, in which both parties guaranteed ET Power's obligations under the Agreement. *Id.* 3a. The guarantees were subject to a $140 million cap on potential liability, *id.*, and provided that any payments made on account of one

guarantee would apply to reduce the maximum exposure under the other guarantee, *id.* 30a-32a & n.5.

On July 8, 2003 (the "Petition Date"), NEGT, ET Power, and others filed chapter 11 petitions, *see* Pet. App. 3a, and the cases were procedurally consolidated. On the Petition Date, the Debtors filed a motion to reject the Agreement, *see* 11 U.S.C. § 365(a), which was granted. *Id.* 4a.[1] Liberty sought rejection damages and approximately $5.4 million in unpaid invoices. *Id.* 4a, 27a.[2] An arbitration panel awarded Liberty $140 million in rejection damages plus interest that accrued after the Petition Date, which totaled $17 million. *Id.* & 5a n.3.

During the arbitration, NEGT and certain non-debtor subsidiaries entered into an agreement to sell all of the issued and outstanding shares of non-debtor GTN. Pet. App. 4a. The bankruptcy court approved the sale. Under the terms of the sale agreements, the face amount of the GTN guarantee ($140 million) was reserved in escrow and held back from the purchase price, and any liability of GTN to Liberty on account of the GTN guarantee would be paid directly from the escrow account, *see* Pet. App. 5a, 28a & n.3; with any remaining balance released

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[1] 11 U.S.C. § 365(a) provides, in pertinent part, that chapter 11 debtors, with the bankruptcy court's approval, "may assume or reject any executory contract or unexpired lease of the debtor."

[2] 11 U.S.C. § 365(g) provides, in pertinent part, that "the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease."

to NEGT, *see* Fourth Circuit Joint Appendix ("JA") 174. After the arbitrators decided in Liberty's favor, the parties agreed that Liberty would receive immediate payment of the escrow amount. Pet. App. 4a-5a, 28a & n.3. Accordingly, Liberty was paid $140 million in full and final satisfaction of the GTN guarantee and, by its terms, the NEGT guarantee. *Id.*

Liberty continued to assert claims against NEGT and ET Power for $140 million each, arguing that NEGT and ET Power remained jointly and severally liable, and that Liberty therefore could continue to assert the full amount of the Award against both Debtors. Pet. App. 5a, 29a. Liberty acknowledged that it could collect at most $17 million (plus outstanding invoices), since it was entitled to no more than one full satisfaction of the Award from all sources. *Id.* 5a. Liberty contended that it could allocate any funds received under the GTN guarantee to post-petition interest and collection costs before applying any portion of those funds to principal. *Id.* 29a.

The Debtors objected to Liberty's proofs of claim against NEGT and ET Power,[3] *see* Pet. App. 6a, 27a,

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[3] When a debtor commences a bankruptcy case, a bankruptcy estate is formed, comprising all the debtor's interests in property, including any such interest acquired thereafter. 11 U.S.C. § 541(a). Creditors' rights to payment against the debtor constitute "claims" against the estate. 11 U.S.C. §§ 101(5), 502(b). Creditors holding pre-petition claims may file a "proof of claim" with the bankruptcy court. 11 U.S.C. §§ 101(10), 501(a); FED.

arguing, *inter alia*, that because Liberty received full satisfaction of its rejection damages from GTN, the $17 million Liberty sought necessarily constituted post-petition interest that must be disallowed under the express terms of 11 U.S.C. § 502(b)(2), *id.*, 29a. They also argued that Liberty should not be entitled to file a $140 million claim against ET Power and NEGT because the value of the claim did not accurately reflect the judgment Liberty could legally obtain against the Debtors. *Id.*

B. The Decisions Below

Noting its belief that the issue presented was one of "novel impression," Pet. App. 33a, the bankruptcy court concluded that: (i) Liberty could apply funds received under the GTN guarantee first to post-petition interest and then assert a claim against ET Power for the entire principal amount of the Award; and (ii) Liberty was not entitled to costs and fees. *Id.* 37a. The bankruptcy court's order allowed Liberty's unsecured claim against ET Power, limiting the maximum distribution on account of such claim to $22 million (the arbitration judgment amount, less the $140 million payment from GTN, plus the

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R. BANKR. P. 3001, 3002. A filed claim is "allowed" automatically if no party in interest objects. 11 U.S.C. § 502(a). If an objection is filed, the court must resolve it and either allow or disallow the claim under section 502(b), which directs that, if an objection to a claim has been filed, the court "shall determine the amount of such claim . . . as of the date of the filing of the petition, except to the extent that [one of the exceptions to allowance listed in section 502(b) applies]." 11 U.S.C. § 502(b).

amount of outstanding invoices), and expunged Liberty's claim against NEGT. *Id.* 23a.

On appeal to the district court, the Debtors argued, *inter alia*, that the bankruptcy court had incorrectly interpreted section 502(b)(2) and erred in allowing a claim against ET Power for amounts equal to post-petition interest on the Award. The district court affirmed the bankruptcy court's order on essentially the same grounds. Pet. App. 20a; JA 377-84.

On further appeal, the Fourth Circuit reversed in a decision that drew three opinions, with the majority concluding that Liberty's unsecured claim was a claim for post-petition interest on the Award that must be disallowed under section 502(b)(2), and that Liberty could not evade this proscription by characterizing the claim as one for principal. Pet. App. 10a. After first concluding that, despite language in the guarantee purporting to make GTN a co-obligor, GTN was a surety for ET Power, and that the "value of ET Power's debt to Liberty under state law [wa]s not reduced by the $140 million received from GTN," the majority turned to the "more fundamental question." Pet. App. 7a-8a. The majority began with the text of section 502(b)(2) and the central bankruptcy policies informing the statute's application:

> The purpose of this section is twofold: (1) the avoidance of unfairness among competing creditors, and (2) the avoidance of administrative inconvenience. As with all sections of the Code, § 502(b)(2) exists to guide the court in the administration of a bankruptcy estate so as to bring about a ratable distribution of as-

> sets among the bankrupt's creditors. Indeed, § 502(b)(2) itself reflects the equitable nature of the Code, and our application of its bar on post-petition interest is to be guided by principles of equity. Thus, in applying § 502(b)(2), we have a duty to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.

Pet. App. 8a-9a (internal quotation marks and citation omitted).

Applying these principles, the majority concluded that Liberty already had received the full value of the debt it was owed by ET Power ($140 million) on the Petition Date and that "§ 502(b)(2) prevents Liberty from collecting the additional $17 million it seeks despite Liberty's classification of that amount as principal." Pet. App. 10a. The majority reasoned:

> On the date the debtors filed their bankruptcy petition, the Agreement was effectively rejected and Liberty sustained damages, although the value of the damages was then unknown and disputed. Subsequently, through arbitration, Liberty's damages were determined to be $140 million. Thus, Liberty's damages and ET Power's debt to Liberty on the petition date was $140 million, and by the terms of § 502(b)(2), Liberty could not collect in bankruptcy any additional amounts added due to the accrual of interest. *Nicholas v. United States*, 384 U.S. 678, 682 (1966) ("[T]he accumulation of interest on claims against a

> bankrupt estate is suspended as of the date the petition in bankruptcy is filed."). This result is not altered simply because Liberty holds a guarantee from a non-debtor third party. Accordingly, the arbitration panel's award of interest on the $140 million in damages, while perhaps appropriate under the Agreement and as a matter of nonbankruptcy law, is not collectable from the debtors in bankruptcy by virtue of § 502(b)(2).

Pet. App. 10a.

The majority explained that "[t]he § 502(b)(2) bar to collection of interest is not overcome by Liberty's classification of the $17 million it now seeks as principal," and that "[r]egardless of how Liberty classifies GTN's payment for its own purposes, we must sift the circumstances surrounding the claim to determine the reality of the transaction for purposes of the bankruptcy proceeding." Pet. App. 11a (internal quotation marks and citation omitted). The majority held that "[b]ecause ET Power's debt was capped at $140 million by the filing of the bankruptcy petition and because the debt was increased only by the accrual of interest pursuant to the arbitration award, we view Liberty's claim for an additional $17 million as disallowed post-petition interest no matter how Liberty chooses to classify it." *Id.*

The majority rejected Liberty's arguments that the court "must accept its classification of GTN's payment as interest rather than as principal because bankruptcy proceedings cannot affect the liability of a non-debtor on a debt," and that barring Liberty

from collecting the additional $17 million from the estate "will essentially relieve GTN of its obligation to pay interest." Pet. App. 11a n.5. The majority emphasized that its decision did not abrogate Liberty's state-law rights against GTN or GTN's liability to Liberty:

> Liberty is free to classify GTN's payment as interest or to pursue collection from GTN at any time. Any limitation of Liberty's right to recover from GTN the full amount it is owed is due to the terms of GTN's guarantee or to non-bankruptcy law, not to our decision here. We merely hold that Liberty may not affect the rights of a party in bankruptcy by its classification of a payment received from a non-debtor guarantor.

Id.

A contrary result, the majority explained, would permit creditors to evade section 502(b)(2) simply by classifying a payment on a debt from a non-debtor guarantor as "nonprincipal, thus preserving the full value of the principal for collection in bankruptcy," and, therefore, it was necessary for the court to determine whether the claim "really constitutes post-petition interest disguised as unpaid principal." Pet. App. 11a-12a. The majority reasoned that if "Liberty had classified GTN's payment of $140 million not as a payment on the debt but as consideration received in return for a covenant not to sue, we would certainly look behind the transaction and would not allow collection as principal of the full $140 million." *Id.* So too, the court must "look behind Liberty's

claim here to find that the claim really constitutes post-petition interest disguised as unpaid principal." *Id.*

The majority further noted that its conclusion is supported by 11 U.S.C. §§ 506(b) and 726(a)(5), which allow recovery of post-petition interest where the creditor is oversecured or the debtor is solvent, respectively. In such cases, allowance of post-petition interest does not result in administrative inconvenience or unfairness to creditors in contravention of the critical bankruptcy policies served by section 502(b)(2). Pet. App. 12a. In contrast, "allowing, Liberty to collect the additional amount it seeks *will* have an impact on ET Power's creditors: namely, the loss of $17 million from the estate which would otherwise be available for distribution." *Id.*

Judge Wilson's concurrence stated the question presented, and his view, as follows:

> Does Liberty's contractual right with GTN, a third party, to allocate principal and interest, that is, to call payments from that guarantor what it wants to call them, preclude the Bankruptcy Court from calling those payments what they are vis-à-vis the bankrupt debtor. That is, can Liberty allocate its way around § 502(b)(2)'s disallowance of unmatured interest. In my view to do so is to simply call a rose by another name.

Pet. App. 13a.

Thus, under the majority and concurring opinions, post-petition interest can accrue against a non-

debtor, but section 502(b)(2) disallows a claim for post-petition interest against the estate. Pet. App. 12a-13a.

In dissent, Judge Duncan stated: "Because neither bankruptcy law nor the contract governing Liberty's relationship with the non-debtor guarantor GTN limits Liberty's right to allocate its recovery from GTN in any manner it wishes, I would affirm." Pet. App. 18a.

Liberty's Petition for Rehearing and Rehearing En Banc was subsequently denied. Pet. App. 39a.

REASONS FOR DENYING THE PETITION

The decision below presents no occasion for certiorari review. First, it does not conflict with any other circuit-court decision. The only issue presented by the decision below is whether section 502(b)(2) bars Liberty's unsecured claim for unmatured interest, notwithstanding Liberty's characterization of the claim as one for principal. No other circuit court has decided this issue, much less decided it in conflict with the majority below. Moreover, courts considering whether an unsecured claim is one for unmatured interest routinely focus on the substance of the claim, not its form, and apply common criteria in analyzing whether allowance or disallowance of the claim under section 502(b)(2) would unfairly prejudice other creditors, provide a windfall to the debtor, or otherwise contravene bankruptcy policy. The majority's approach fully comports with that employed by other courts in applying section 502(b)(2), and Liberty cites nothing to the contrary. The majority's

analysis also is consistent with, and supported by, decisions construing other Bankruptcy Code provisions; in particular, cases applying section 502(b)(6).

Second, the majority's statutory analysis does not conflict with *Travelers Cas. & Surety Co. v. Pac. Gas. & Elec. Co.*, 127 S. Ct. 1199 (2007), or with any of the Court's decisions concerning the interplay between state law and federal bankruptcy law. Federal law governs the question whether to allow interest on claims against a debtor's bankruptcy estate. In *Travelers*, no section 502(b) provision barred Travelers' unsecured claim for attorneys' fees. Here, the majority determined that Liberty's unsecured claim was not a claim for principal, but rather an unsecured claim for unmatured interest, which is expressly barred by section 502(b)(2)'s plain text. The majority's decision also is entirely consistent with this Court's precedents concerning the proper construction of bankruptcy statutes, in accordance with the statute's plain text, with due regard for the fundamental policies served by the statute and the Bankruptcy Code, as well as the statute's history and relationship with other Code provisions.

Third, further development in the lower courts is warranted, and certiorari review is premature, given the absence of a conflict with this Court's precedents and that no other circuit court has addressed the question decided below – whether a creditor of a bankrupt debtor can defeat section 502(b)(2)'s proscription against allowance of claims for unmatured interest by allocating a payment from a non-debtor guarantor first to interest, then to principal, and

then characterizing its claim as one for principal in order to collect against a bankrupt primary obligor.

Fourth, the circuit split alleged by Liberty concerns a claimed disagreement concerning completely different questions – involving section 510(c) of the Bankruptcy Code and issues of equitable subordination and disallowance – that are irrelevant to the question decided by the Fourth Circuit and that were neither briefed nor decided below. Nor is the majority's decision an indiscriminate invocation of equitable principles unmoored from any statutory text, as Liberty contends. To the extent it applied equitable principles in denying Liberty's claim for unmatured interest, the majority properly considered fundamental policies underlying the Bankruptcy Code and specifically informing application of section 502(b)(2) and, consistent with the decisions of this and other courts, did so to enforce that statute's express proscription against allowing unsecured claims for unmatured interest.

Finally, the decision below presents no issue of extraordinary public importance warranting this Court's intervention. The allegations of Liberty and its *Amicus* concerning the purportedly ruinous effects of the majority's decision on commercial expectations and the credit markets are unfounded. The majority simply applied section 502(b)(2) as written, with proper regard for the policies and purposes the statute and the Bankruptcy Code were enacted to serve, and the only parties affected are the parties to this case and the Debtors' other creditors. Importantly,

the majority expressly confirmed that Liberty is free to pursue its state-law rights against GTN.

For these reasons, Liberty's petition should be denied.

A. The Majority's Decision Creates No Circuit Split Concerning Application Of Section 502(b)(2).

Liberty contends that the majority's decision "creates a three-way conflict among the circuits regarding when, if ever, a federal court may rely on equitable principles to disallow an otherwise valid claim in bankruptcy." Pet. 10. But the only question presented to and decided by the Fourth Circuit is whether section 502(b)(2) bars Liberty's unsecured claim for post-petition interest, notwithstanding Liberty's characterization of the claim as one for principal. No other circuit court has addressed this issue in the context of a creditor's allocation of payment from a non-debtor-guarantor, much less decided it in conflict with the majority's decision. No circuit split justifies certiorari review of the decision below.

1. The majority's analysis comports with that employed by other courts in considering whether an unsecured claim includes unmatured interest.

In construing and applying section 502(b)(2), courts routinely employ a "few common principles," examining the context of the particular transaction; the statute's history and purpose; its relationship to other Bankruptcy Code provisions; the policies underlying the Code; and the equities involved. *E.g.*, *In*

re Thrifty Oil, 322 F.3d 1039, 1047-48 (9th Cir. 2003) (collecting cases). The majority's decision fully comports with this analysis.

In *Thrifty Oil*, the court considered whether termination damages under an interest-rate swap contract constituted unmatured interest. After citing section 502(b)(2)'s text, the court explained that "[f]ederal law, not state law, governs a creditor's entitlement to post-petition interest on a valid prepetition claim." 322 F.3d at 1046 (citing *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946)). The court then explained the origins of the rule "curtailing" the accrual of post-petition interest on amounts owed by debtors, *id.* at 1046-47 (citing *Sexton v. Dreyfus*, 219 U.S. 339, 344 (1911)), and discussed the rule's purpose:

> [T]he Bankruptcy Code maintains the rule to achieve fairness and administrative efficiency in bankruptcy cases. The most significant reasons for the rule include: (1) because a bankruptcy suspends a debtor's ability to pay its debts, requiring payment of post-petition interest penalizes the debtor for something over which it has no control; (2) denying post-petition interest saves the bankruptcy estate the inconvenience of continuously recalculating the amount due each creditor; and most importantly, (3) denying post-petition interest ensures that no party realizes a gain or suffers a loss due to the delays inherent in liquidation and distribution of the estate.

322 F.2d at 1047 (citing *Vanston*, 329 U.S. at 162-63; *In re Fesco Plastics Corp.*, 996 F.2d 152, 155 (7th Cir. 1993)); *see Gamble v. Wimberly*, 44 F.2d 329, 333 (1930) (rejecting *secured* creditor's application of proceeds from sale of collateral first to post-petition interest then to principal, stating that "proceeds from collateral held by a secured debtor must be applied to the liquidation of the debt with interest to the date of the petition only, and cannot be applied to interest accruing since that time").

Noting the "infinite variety of transactions that may trigger an unmatured interest objection," the *Thrifty* Court enumerated the following "common principles" applied in determining whether a claim includes unmatured interest disallowed by section 502(b)(2). 322 F.3d at 1047. First, "courts generally focus on the substance of the claim, not its form and may rely on evidence outside the parties' agreement." *Id.* (citing cases). Second, "[w]here the specific characteristics of a transaction create uncertainty as to whether a claim includes unmatured interest, federal courts do not base their decisions on economic theories of interest. Instead, they evaluate the transaction in light of the principles that underlie Section 502(b)(2) and the policies that flow throughout the Bankruptcy Code." *Id.* (citing *Vanston*, 329 U.S. at 165); *see id.* at 1050 ("the resolution of this issue does not turn on economic theories of interest, but on equitable principles and bankruptcy policy"). Such cases "often turn on whether allowance or disallowance will contravene bankruptcy policy, unfairly prejudice other creditors or provide a windfall to the

debtor." *Id.* at 1047-48 (citing *Bruning v. United States*, 376 U.S. 358, 363 (1964), and decisions within the Second, Fifth, Eighth, Ninth, and Tenth Circuits).

The courts in these cases, and the *Thrifty* Court itself, reached a different conclusion from that of the majority below. Critically, however, these courts applied section 502(b)(2) in the same way the majority did – *i.e.*, focusing on "the reality of the transaction for purposes of the bankruptcy proceeding," Pet. App. 11a-12a, and with proper regard for the duty of courts to apply section 502(b)(2) consistent with the "equitable nature" of the statute and the Code, *id.* 9a.

The Seventh Circuit applied a similar analysis in *Fesco*, rehearsing the history of the proscription against recovery of post-petition interest and the policies it serves, and rejecting creditors' "attempt to sidestep § 502(b)(2)'s bar on post-petition interest by noting that it only refers to interest on *claims*, while they are seeking interest on their tardy 40% *distributions*." 996 F.2d at 155-56. The court concluded:

> This semantic sleight-of-hand is unpersuasive. Although it is true that the . . . creditors only want interest for the period between the earlier distribution and the time they received their distributions, rather than from the date of the petition, *the fact is that they are requesting interest that would have had to accrue after the petition was filed*. The cases and § 502(b)(2), however, make it clear that interest stops accruing when the petition is filed.

Id. at 156 (emphasis supplied) (citing *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 246 (1989); 2 COLLIER ON BANKRUPTCY, ¶ 502.02[2] at 502-30 (Lawrence P. King ed., 15th ed. 1993)). *See Brown v. Sayyah (In re ICH Corp.)*, 230 B.R. 88, 94 (N.D. Tex. 1999) ("Undersecured creditors are not permitted to recover any part of a debt that represents unaccrued interest as of the filing of the bankruptcy petition, even if the parties have tried to disguise the interest as principal."); *cf. United States v. Energy Res. Co.*, 495 U.S. 545, 551 (1990) (bankruptcy court could order IRS to treat tax payments by a chapter 11 debtor corporation as trust fund payments, rather than non-trust liabilities, notwithstanding that this could result in IRS not recovering the full amount of debtor's tax liabilities). Liberty cites *no* decision holding that courts must accept uncritically an unsecured creditor's characterization of its claim in applying section 502(b)(2).

To similar effect in the guarantee context is *Aetna Bus. Credit, Inc. v. Hart Ski Mfg. Co. (In re Hart Ski Mfg. Co.)*, 7 B.R. 465 (Bankr. D. Minn. 1980). There, the debtor purchased inventory from a supplier via letters of credit, and its obligation to the issuing bank was guaranteed by non-debtor Aetna, which held a first lien on the debtor's property. *Id.* at 466-67. After the debtor filed for bankruptcy, the creditor-bank demanded payment on the letters of credit from the debtor and Aetna. *Id.* at 467. The court disallowed any claim for post-petition interest, reasoning that because "Aetna's obligation is limited to the obligation owed by [the debtor to the bank] . . .

[and the debtor] could not owe [the bank] interest, therefore, Aetna is not liable for such interest." *Id.* at 469. Because Aetna's indemnification claim under the guarantee was fully collateralized, *id.* at 468, any recovery against Aetna would have diminished the debtor's estate by a like amount. The court concluded that to allow the bank to recover post-petition interest from Aetna would have impermissibly "allowed [the bank] to accomplish indirectly what it could not accomplish directly under § 502(b)(2)." *Id.* at 469.

2. The majority's decision comports with the Bankruptcy Code as a whole and courts' application of related Code provisions.

Recognizing that the Bankruptcy Code was intended to function as a coherent regulatory scheme, the Court has directed that its provisions should be construed together, taking into account the relationships among the provisions. *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 369-72 (1988) (construing sections 361, 362 and 506 and observing that "[s]tatutory construction . . . is a holistic endeavor"); *Kelly v. Robinson*, 479 U.S. 36, 43 (1986) ("In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law") (internal quotations marks and citations omitted). As the Court explained in *Timbers*, "[a] provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme - because the same terminology is used elsewhere in a context that

makes its meaning clear, or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law." 484 U.S. at 371 (citations omitted).

There appears to be no other circuit-court decision concerning the effect of a creditor's recovery against a third-party on an underlying claim against a debtor that is otherwise limited by section 502(b)(2). The majority's decision, however, is entirely consistent with decisions applying other Code provisions; in particular, other claim-limiting provisions of section 502(b), which exist for the protection of debtors who avail themselves of the benefits and burdens of bankruptcy. *See, e.g., Stellwagen v. Clum*, 245 U.S. 605, 617 (1918). For example, the majority's holding is supported by analogous decisions regarding the effect of third-party recoveries on claims limited by section 502(b), which caps a landlord's claim in bankruptcy for damages resulting from termination of an unexpired lease.[4] At least three appellate courts have required creditors receiving recoveries from third-parties to apply such proceeds to the *capped* portion

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[4] Section 502(b)(6) provides, in pertinent part, that a "claim of a lessor for damages resulting from the termination of a lease of real property" is disallowed if "such claim exceeds- (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of- (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates." 11 U.S.C. § 502(b)(6).

of their claims, which is the same result mandated by the majority's decision here. *See AMB Prop., L.P. v. Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*, 416 F.3d 961, 965 (9th Cir. 2005); *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 301 (B.A.P. 9th Cir. 2004); *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 210 (3d Cir. 2003).

In *PPI*, a landlord argued that it was entitled under applicable state law to apply funds drawn on a standby letter of credit and received from a third-party to the *disallowed*, rather than the allowed, portion of its claim against the debtor-tenant, thereby leaving a claim against the debtor-tenant in its full, allowable amount, with no credit applied to account for the third-party recovery. 324 F.3d at 209-10. The Third Circuit rejected the argument, holding that it was immaterial whether the funds came from a third-party or from the debtor: "The difference is purely technical [and] . . . insufficient to justify divergent rules as to the respective allowable claims. If the total damages are limited in the one instance, they should likewise be limited in the other instance." *Id.* at 210 (quoting *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 921 (2d Cir. 1944)). The majority's decision below is entirely consistent with and supported by these decisions, as there is no reason why they should not apply here.

The majority's decision also is consistent with and supported by cases applying 11 U.S.C. §§ 506(b) and 726(a)(5), which allow recovery of post-petition inter-

est where the creditor is oversecured or the debtor is solvent, respectively, in circumstances in which allowance of post-petition interest does not result in administrative inconvenience or unfairness to creditors in contravention of the policies served by section 502(b)(2). Pet. App. 12a (citing cases); *see, e.g., United States v. Alaska Nat'l Bank (In re Walsh Constr., Inc.)*, 669 F.2d 1325, 1330 (9th Cir. 1982); *Gamble*, 44 F.2d at 333. In contrast to those circumstances, as the majority noted below, "allowing, Liberty to collect the additional amount it seeks *will* have an impact on ET Power's creditors: namely, the loss of $17 million from the estate which would otherwise be available for distribution." Pet. App. 12a.

In sum, there is no circuit split concerning the question whether an unsecured claim includes post-petition interest for purposes of section 502(b)(2), and Liberty cites none. Nor could it, as no other circuit court has considered the precise question addressed in the decision below, and courts routinely employ a consistent approach with which the majority's analysis fully comports. The majority's decision also is consistent with and supported by analogous decisions concerning other Code provisions, including other claim-limiting provisions of section 502(b), and this approach too fully comports with the Court's precedents concerning the proper construction of the bankruptcy statutes. Accordingly, Liberty's petition should be denied.

B. The Majority's Decision Does Not Conflict With, And Is Supported By, This Court's Precedents.

1. Federal law governs a creditor's entitlement to post-petition interest on valid pre-petition claims.

The filing of a bankruptcy petition initiates a process that requires some temporal point of demarcation to facilitate the orderly resolution of the debtor's obligations. "The age-old rule in bankruptcy, adopted from the English system, is that interest on claims stops accruing when the bankruptcy petition is filed." *Fesco*, 996 F.2d at 155 (citing *Ron Pair*, 489 U.S. at 246; *Nicholas*, 384 U.S. at 682; *Bruning*, 376 U.S. at 362; *City of New York v. Saper*, 336 U.S. 328, 330 n.7 (1949); *Vanston*, 329 U.S. at 163; *Sexton*, 219 U.S. at 344). *See* H.R. REP. NO. 95-595, at 352-53 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6308-09; S. REP. NO. 95-989, at 62-63 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5848-49.

It is well settled that federal law, not state law, governs a creditor's entitlement to post-petition interest on a valid pre-petition claim. *Vanston*, 329 U.S. at 162-63 ("When and under what circumstances federal courts will allow interest on claims against debtors' estates being administered by them has long been decided by federal law."); *see BFP v. Resolution Trust Corp.*, 511 U.S. 531, 545 (1994) (operation of the Bankruptcy Code is "unimpeded by contrary state law" where the "meaning of the Bankruptcy Code's text itself is clear") (quotation omitted);

Kellogg v. United States (In re W. Tex. Mktg. Corp.), 54 F.3d 1194, 1196 (5th Cir. 1995) (discussing the validity of creditors' claims for interest and noting that "once the petition is filed, federal law controls"). Accordingly, Liberty's reliance on *Travelers* and similar decisions, *see* Pet. 17-18, is misplaced.

As the Court explained in *Travelers*, "claims enforceable under applicable state law will be allowed in bankruptcy *unless they are expressly disallowed*." 127 S. Ct. at 1206 (emphasis supplied). Whereas no Code provision barred Travelers' unsecured claim for attorneys' fees, section 502(b)(2) expressly bars Liberty from collecting unmatured interest on its unsecured claim. *See also Energy Resources*, 495 U.S. at 549 ("[B]ankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships."); *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 71 (1982) ("the restructuring of debtor-creditor relations . . . [lies] at the core of the federal bankruptcy power"); *Ashton v. Cameron County Water Improvement Dist. No. One*, 298 U.S. 513, 530 (1936) ("The especial purpose of all bankruptcy legislation is to interfere with the relations between the parties concerned – to change, modify or impair the obligations of their contracts."); *Continental Ill. Nat'l Bank & Trust Co. v. Chicago, R.I. & Pac. Ry. Co.*, 294 U.S. 648, 680 (1935) ("Congress . . . undeniably, has authority to pass legislation pertinent to any of the powers conferred by the Constitution however [and] it may operate collaterally or incidentally to impair or destroy the obligation of private contracts.").

The majority's decision neither abrogates a creditor's state-law rights nor rewrites contracts under general principles of equity, but merely holds that a particular creditor's unsecured claim against a particular debtor for post-petition interest must be disallowed under section 502(b)(2) of the Bankruptcy Code. Pet. App. 11a-12a & n.5.

Liberty's assertion that the majority's decision contravenes section 524(e) fails for the same reason. Section 524(e) provides, in relevant part, that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e). Because GTN's liability to Liberty is unaffected by the bankruptcy proceedings, as the majority explained, the concern regarding section 524(e) is unfounded. Pet. App. 11a n.5. Under the majority's decision, post-petition interest can accrue against a non-debtor, but section 502(b)(2) disallows an unsecured claim for post-petition interest against the bankruptcy estate. *Id.* 11a-13a. GTN's liability to Liberty as a guarantor was contractually capped at $140 million, and this liability has been fully satisfied. *Id.* 3a, 5a.

2. The Court's precedents establish that application of the rule barring unsecured creditors from recovering unmatured interest should be informed by the policy of equality of distribution and equitable principles.

The Court has recognized the importance of history to the construction of bankruptcy statutes.

Duparquet Huot & Moneuse Co. v. Evans, 297 U.S. 216, 218 (1936). The rule embodied in section 502(b)(2) is deeply ingrained in the Court's jurisprudence. *E.g.*, *Saper*, 336 U.S. at 330-32; *United States v. Marxen*, 307 U.S. 200, 207 (1939); *American Iron & Steel Mfg. v. Seaboard Air Line R. Co.*, 233 U.S. 261, 266 (1914). The Court has stated the central purposes of the rule as ensuring equitable distribution of the estate among competing creditors and avoiding administrative inconvenience. *Nicholas*, 384 U.S. at 682; *Bruning*, 376 U.S. at 362; *Vanston*, 329 U.S. at 166; *Ticonic Nat'l Bank v. Sprague*, 303 U.S. 406, 411 (1938). The Court also has repeatedly recognized the ancient policy underlying the Bankruptcy Code of equality of distribution among similarly situated creditors under circumstances in which not everyone can be paid in full. *E.g.*, *Begier v. IRS*, 496 U.S. 53, 58 (1990) (noting that "[e]quality of distribution among creditors is a central policy of the Bankruptcy Code"); *see Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co.*, 126 S. Ct. 2105, 2116 (2006); *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991); *Young v. Higbee Co.*, 324 U.S. 204, 210 (1945); *Straton v. New*, 283 U.S. 318, 320-21 (1931). The Bankruptcy Code's post-petition rules were described in the legislative materials as codifying "present law." S. REP. NO. 95-989, at 63 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5849.

Vanston leaves no doubt that courts *must* apply the rule barring unsecured creditors from recovering unmatured interest from the estate informed by the

policy of equality of distribution and equitable principles:

> [B]ankruptcy courts must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles. And we think an allowance of interest on interest under the circumstances shown by this case would not be in accord with the equitable principles governing bankruptcy distributions.

329 U.S. at 162-63; *see id.* at 164 ("Courts have felt that it would be inequitable for anyone to gain an advantage or suffer a loss because of such delay.") (citing *Sexton*, 219 U.S. at 346); *id.* at 165 (It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor.") (citing *Sexton*, 219 U.S. at 346); *id.* at 166 (explaining that added compensation for creditors or a penalty to induce prompt payment of simple interest would have enriched some creditors at the expense of subordinate creditors and that "[s]uch a result is not consistent with equitable principles"). *See also Howard Delivery*, 126 S. Ct. at 2116 (noting, in rejecting creditor's claim to section 507(a)(5) priority, that "[e]very claim granted priority status reduces the funds available to general unsecured creditors and may diminish the recovery of other claimants qualifying for equal or lesser priorities," and direct-

ing that "[a]ny doubt concerning the appropriate characterization . . . is best resolved in accord with the Bankruptcy Code's equal distribution aim"); *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 451-52 (1937) (upholding section 502(b)(6) predecessor against a constitutional challenge, stating: "The equitable distribution of the bankrupt's assets, or the equitable adjustment of creditors' claims in respect of those assets, by way of reorganization, may . . . be regulated by a bankruptcy law which impairs the obligation of the debtor's contracts. Indeed every Bankruptcy Act avowedly works such impairment.").

Liberty's citations to *United States v. Pollack*, 370 F.2d 79, 80 (2d Cir. 1966), *Darr v. Muratrore*, 8 F.3d 854 (1st Cir. 1993), and *Story v. Livingston*, 38 U.S. 359, 371 (1839), provide no basis for granting Liberty's petition, as none of these cases involve claim-allowance proceedings in bankruptcy or section 502(b)(2). *Vanston*, 329 U.S. at 165 n.9 (distinguishing cases, explaining that "[n]one of them presented to the courts the special bankruptcy problems of uniformity, ratable distribution and fairness and equity which grow out of the context of the bankruptcy law"). Moreover, the liens in *Pollack* belonged to the same creditor and, thus, unlike here, the creditor's decision to apply payment toward interest before principal did not affect competing creditors' rights. 370 F.2d at 80.

In sum, the Court's precedents establish beyond peradventure that the fundamental policies undergirding 502(b)(2) and the Bankruptcy Code are properly considered in determining whether an unsecured

claim includes unmatured interest, and Liberty cites no section 502(b)(2) case to the contrary. Liberty's mischaracterization of the majority's decision notwithstanding, the majority's consideration of equity in determining whether allowance or disallowance of Liberty's claim would serve these policies was hardly an unbridled act of a roving commission invoking general principles of equity unmoored from the statute's text. The majority's decision does not conflict with the Court's precedents applying the proscription against allowing unsecured claims for unmatured interest or concerning construction of the Bankruptcy Code's provisions, and the majority correctly decided the question presented.[5] Liberty's petition should be denied.

C. Certiorari Review Is Premature Because No Other Circuit Court Has Addressed The Application Of Section 502(b)(2) In This Context.

As discussed, there is ample and consistent decisional law addressing whether a particular unsecured claim includes unmatured interest barred by section 502(b)(2); application of third-party recoveries to claims capped by section 502(b)(6); and proper

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[5] Respondents contend that the majority erroneously rejected their argument that Liberty's claim must be reduced by the amount recovered from GTN under applicable state law, *see* Pet. App. 7a-8a, and that a correct application of the governing law independently supports the conclusion reached by the majority in its section 502(b)(2) analysis. Liberty's petition does not rely on this ruling.

interpretation of the Bankruptcy Code's provisions. No other circuit-court decision, however, addresses the precise issue decided below, and Liberty cites no decision that does. The bankruptcy court observed that the question is an issue "of novel impression," Pet. App. 33a, and the panel below issued three opinions. Under the circumstances, further development of the issue in the lower courts is warranted, and Liberty's petition should be denied. *See Arizona v. Evans*, 514 U.S. 1, 23 n.1 (1995) (Ginsburg, J., dissenting) ("[W]hen frontier legal problems are presented, periods of 'percolation' in, and diverse opinions from, state and federal appellate courts may yield a better informed and more enduring final pronouncement by this Court."); *Butler v. McKellar*, 494 U.S. 407, 431 n.12 (1990) (Brennan, J., dissenting) (noting the value of "[t]he process of percolation allow[ing] a period of exploratory consideration and experimentation by lower courts before the Supreme Court ends the process with a nationally binding rule") (alterations in original; internal quotation marks and citation omitted); *Maryland v. Baltimore Radio Show*, 338 U.S. 912, 918 (1950) (Frankfurter, J., respecting denial of certiorari) ("It may be desirable to have different aspects of an issue further illuminated by the lower courts. Wise adjudication has its own time for ripening.").

D. Liberty's Alleged Circuit Split, Manufactured By Mischaracterizing The Majority's Decision And Invoking Inapposite Code Provisions, Provides No Basis For Certiorari Review.

Liberty's claimed circuit split concerns decisions examining equitable principles underlying the subordination of claims under section 510(c) of the Bankruptcy Code and issues of equitable subordination and disallowance – issues that were neither briefed nor decided below. Any disagreement among the circuits on these issues provides no basis for certiorari review of the decision below.

Section 510(c) allows courts, "under principles of equitable subordination, [to] subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest." 11 U.S.C. § 510(c). It applies where a creditor's claim is legally enforceable and allowable, but the creditor's misconduct warrants an equitable remedy. In such circumstances, courts will subordinate that creditor's claim until other creditors' claims have been satisfied. *See, e.g., Benjamin v. Diamond* (*In re Mobile Steel Corp.*), 563 F.2d 692, 700 (5th Cir. 1977).

Neither section 510(c) nor any of Liberty's cited cases address whether an unsecured claim should be disallowed under section 502(b)(2), and so are inapplicable to the issue presented here. Indeed, Liberty acknowledges that the Debtors have not argued, and that the courts below did not decide, that Liberty's

claim should be subordinated because of Liberty's conduct. Pet. 19.

So too with the cases Liberty cites as evidencing a circuit split concerning whether equitable disallowance requires evidence of creditor misconduct. Pet. 15. The question whether Liberty's claim should be "equitably disallowed" was neither briefed nor decided below and Liberty's cited cases do not address whether an unsecured claim includes unmatured interest for purposes of section 502(b)(2). Although Liberty's cited decisions are silent on the statutory basis for equitable disallowance of claims based on creditor misconduct, it is clear that such authority would have to be grounded in 11 U.S.C. § 502(b)(1) or 11 U.S.C. § 105(a). Under section 502(b)(1), a claim may be disallowed if it would be rendered unenforceable under applicable law due to, *inter alia*, fraudulent, unconscionable, or usurious conduct by a creditor. 4 COLLIER, ¶ 502.03[2][b]; *Kapp v. Naturelle, Inc.* (*In re Kapp*), 611 F.2d 703 (8th Cir. 1979). Because Liberty's cited cases do not involve claims for post-petition interest, their holdings and reasoning are irrelevant to the decision below.

In sum, sections 510(c) and 502(b)(1) concern inapposite issues of how claims should be treated based on a creditor's conduct. Liberty's assertion of a circuit split concerning these issues thus provides no warrant for certiorari review of the decision below. *See, e.g., Cooper Indus., Inc. v. Aviall Servs., Inc.*, 543 U. S. 157, 168-69 (2004) ("We ordinarily do not decide in the first instance issues not decided below.") (internal quotation marks and citation omitted).

E. The Petition Presents No Issue of Extraordinary Public Importance Warranting This Court's Intervention.

Liberty and its *Amicus* contend that if the decision below is "left intact, creditors will be unable to predict when their valid state law claims will be allowed in bankruptcy" and that "this uncertainty inevitably will impair the market for commercial credit." Pet. 20-21; Amicus Br. 6. These contentions are unsupported and illogical.

The professed concern that the majority's decision will adversely impact the value of third-party guarantees and the cost of credit in the commercial markets rests on unfounded speculation. The majority *expressly confirmed* Liberty's right to pursue non-debtor guarantor GTN to the full extent of Liberty's state-law rights, and clarified that its decision affects only the amount of Liberty's claim against ET Power, a debtor protected by section 502(b)(2) as well as the primary obligor under the Agreement. Pet. App. 11 n.5. Thus, the argument of Liberty and its *Amicus* is necessarily predicated upon the dubious notion that lenders and others extending unsecured credit take a primary obligor's projected *bankruptcy* distributions into account in deciding whether to lend on the strength of a third-party guarantee. But the whole purpose of such a guarantee is to mitigate the need to rely on the primary obligor's creditworthiness. Accordingly, lenders *without* third-party guarantees likely are more concerned about the creditworthiness of the primary obligor than are lenders holding such guarantees. This would explain why the GTN guar-

antee provided for a reduction in the guarantor's maximum exposure over time as ET Power's expected maximum liability under the Agreement decreased, but did not provide any similar adjustments based upon ET Power's creditworthiness. Pet. App. 31a; JA 28. Liberty apparently obtained the GTN guarantee precisely so that it could rely on GTN's valuable, stable, pipeline assets for its recoveries in the event of a default, rather than on ET Power's creditworthiness.

This is not to deny that lenders with guarantees may take their primary obligor's creditworthiness into account in making lending decisions. But Liberty's argument goes far beyond that proposition. It necessarily suggests that, where the primary obligor files for bankruptcy, the lender, *ex ante*, counts on obtaining a particular distribution from the debtor-obligor's estate as an unsecured creditor. Far more likely is that, for risk-assessment purposes, an unsecured lender's risk of its obligor's bankruptcy equates with that of receiving a zero-dollar recovery on its claim.

That Liberty is contractually barred from recovering additional amounts from non-debtor guarantor GTN is a liability of its own making, and is irrelevant to whether Liberty's unsecured claim is one for unmatured interest proscribed by section 502(b)(2), as the majority below properly recognized. Pet. App. 11a n.5. The majority's decision neither abrogates a creditor's state-law rights against third-party non-debtors nor rewrites contracts under general principles of equity, as Liberty and its *Amicus* contend, but

simply holds that a particular creditor's unsecured claim against a particular bankrupt debtor for post-petition interest must be disallowed under section 502(b)(2). *Id.*

Also unavailing is the contention that the majority' s decision conditions the amount of a creditor's recovery upon the order in which it pursues payment from a debtor and guarantor. Pet. 22; Amicus Br. 7-10. If debtor NEGT had satisfied Liberty's $140 million claim, section 502(b)(2) clearly would have prohibited allocation of any portion of that sum to post-petition interest. With the $140 million principal claim having been paid in full by NEGT, the GTN guarantee would, by its terms, have been satisfied in full, *see* Pet. App. 30a-32a & n.5, and Liberty would have been unable to pursue a claim for post-petition interest against either guarantor. Liberty likewise would have been prevented from seeking additional recovery from ET Power, whose debtor status would protect it from any claim for post-petition interest under section 502(b)(2). Thus, the sequence in which Liberty pursued its claims would not change the amount of the recovery to which it is entitled.

The assertion of Liberty's *Amicus* that the majority's decision confers a "windfall on the guarantor at the creditor's expense" with no countervailing benefit to the estate, *see* Amicus Br. 10-12, also is incorrect. GTN cannot assert a reimbursement claim against ET Power because the GTN sale agreements provided that GTN's liability to Liberty would be paid directly from the escrow, *see* Pet. App. 5a, 28a & n.3, and any remaining balance to NEGT, *see* JA 174.

GTN thus was fully protected under its guarantee by the escrow funds, and debtor NEGT, rather than non-debtor GTN, is the entity holding potential subrogation or reimbursement claims against ET Power on account of the $140 million payment to Liberty.

If NEGT sought subrogation to Liberty's claim as a co-obligor, the claim would be subordinated to the extent of any distributions to which Liberty is entitled. 11 U.S.C. §§ 509(a), (c). Accordingly, any distributions to Liberty from ET Power would diminish NEGT's recovery from ET Power, and NEGT's creditors would bear the burden of Liberty's claim for post-petition interest. On the other hand, if NEGT asserted, in lieu of subrogation, an indemnification claim against ET Power under 11 U.S.C. §§ 502(e)(2), that claim would be subordinated to Liberty's claim until Liberty's claim is "paid in full, either through payments [under the Bankruptcy Code] or otherwise." 11 U.S.C. § 509(c).[6] Once it receives its distribution from ET Power, Liberty will have been paid in full, and, accordingly, NEGT's reimbursement claim would no longer be subordinated. NEGT may then take the position that it should be allowed to assert (and receive distributions on) its entire claim of $140 million, without limitation.

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[6] *See* 4 COLLIER ¶ 509.02[3] ("If the codebtor has paid the original claimant, the codebtor has a choice of whether to proceed as a claimant under section 502(e)(2) or to seek a right of subrogation under section 509.").

The outcome of this potential inter-debtor dispute, which was rendered moot by the decision below, is, in any event, not relevant to Liberty's petition. If Liberty were to receive any additional distributions, the *only* possible source for such recovery would be NEGT and/or ET Power. Accordingly, at least one of the Debtors' estates, and thus, other creditors, would bear the burden of Liberty's claim for post-petition interest.

Liberty's petition thus fails to demonstrate the existence of an issue of extraordinary public importance requiring this Court's intervention. The only interest at stake here is Liberty's interest in increasing its *pro rata* share of the Debtors' estates at the expense of other creditors. This Court's intervention is unwarranted and the petition should be denied. *Rice v. Sioux City Mem'l Park Cemetery*, 349 U.S. 70, 74 (1955); *Layne & Bowler Corp. v. Western Well Works*, 261 U.S. 387, 393 (1923).

CONCLUSION

For the foregoing reasons, the Court should deny the petition.

Respectfully submitted,

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No. 07-684

IN THE

Supreme Court of the United States

LIBERTY ELECTRIC POWER, LLC,

Petitioner,

v.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.),

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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CORPORATE DISCLOSURE STATEMENT

Petitioner's Corporate Disclosure Statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that Statement.

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PRELIMINARY STATEMENT

The Opposition is a testament to why *certiorari* should be granted in this case. Only by reframing the "Question Presented" can ET Power argue that this case involves a garden-variety application of Bankruptcy Code § 502(b)(2) unworthy of this Court's consideration. This difference in framing the "Question Presented" is fundamental. ET Power tries to divert attention from the underlying question this Court should review: whether judicial recharacterization of Liberty's valid state law claim can defeat Liberty's recovery in bankruptcy for the remaining principal due and owing after allocating interest previously paid by a non-debtor guarantor?

The Fourth Circuit refused to adhere to state law in disallowing Liberty's claim. Neither the Opposition nor the decision below disputes that Liberty has a valid state law claim for *principal* because it is entitled to: (i) allocate its recovery from GTN first to interest, (ii) apply the remaining GTN recovery to principal, and then (iii) enforce its remaining principal claim against ET Power. *See* App. 11a n.5, 13a. To address what it perceived as inequity, the Fourth Circuit *sua sponte* invoked "broad equity powers" to "recharacterize" Liberty's claim as *interest*, even though under state law, it is actually *principal*. Only because of this *recharacterization* could it then invoke section 502(b)(2) to disallow Liberty's claim as unmatured interest.[1]

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[1] As Justice Frankfurter noted, "Putting the wrong questions is not likely to beget right answers even in law." *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 170 (1946) (concurring opinion).

The fundamental flaw in this reasoning is that the Fourth Circuit lacked authority to recharacterize Liberty's claim in the first place. The Bankruptcy Code provides no such authority, in section 502 or otherwise. Neither the decision below nor the Opposition points to *any* Bankruptcy Code section authorizing "equitable recharacterization" of a claim for principal.

The Fourth Circuit's disallowance of Liberty's principal claim in the absence of inequitable conduct violates section 510(c). Despite ET Power's protestations that section 510(c) is irrelevant because the majority opinion did not mention it, section 510(c) is the Code's only provision wherein Congress permitted resort to "equitable principles" to impact creditors' claims.[2] And it only authorizes *subordination*, not *disallowance*.

ET Power's argument that no circuit split exists relating to the post-petition interest exception in section 502(b)(2) misses the point – the relevant issue concerns the resort to "equity" to disallow valid state law claims, in violation of sections 502(b) and 510(c). Moreover, the ruling below is at odds with other circuits' rulings applying both sections 502(b)(2) and 510(c). The circuits disagree about the scope of bankruptcy court authority to use "equitable principles" to disallow claims that are – in this case, concededly – valid under state law. All six circuits addressing the issue – *other than the decision below* – require proof of inequitable conduct to trigger equitable subordination or disallowance of otherwise valid claims. Five of the six permit either disallowance

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[2] That the Fourth Circuit ignored section 510(c) underscores the need for this Court's review.

or subordination; the Fifth Circuit permits only subordination. In conflict with six other circuits, the Fourth Circuit disregarded the predicate requirement of inequitable conduct: it *disallowed* a claim based on what it perceived to be inequity, *without any evidence or findings of fact* to support this conclusion, and contrary to the actual findings of the bankruptcy court. This case presents an issue similar to that expressly reserved in *United States v. Noland*, 517 U.S. 535, 543 (1996): "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated."

The decision below suffers from the same analytical flaw as that addressed in *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.*, 127 S. Ct. 1199 (2007) – federal courts enlisting "equity" to disallow otherwise valid and enforceable claims, in contravention of state law and untethered to any statutory authorization in the Bankruptcy Code. The clear-cut circuit split here requires *certiorari* review to resolve fundamental questions of claims allowance in bankruptcy and to prevent the further development of yet another *Fobian*-like judge-made rule of claim disallowance in bankruptcy.

RESPONDENTS' OPPOSITION IS UNFOUNDED

I. The Decision Below Conflicts With This Court's Precedents Governing The Interplay Between State Law And Bankruptcy Claims Allowance.

The threshold question for allowability is whether Liberty's contract claim is valid and enforceable under applicable state law. *See Travelers*, 127 S. Ct. at 1206 ("claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed"); *Raleigh v. Ill. Dept. of Revenue*, 530 U.S. 15, 20 (2000) ("The 'basic federal rule' in bankruptcy is that state law governs the substance of claims") (quoting *Butner v. United States*, 440 U.S. 48, 57 (1979)).

Under state law, Liberty's claim is unquestionably for principal. A claim for principal is not disallowed by section 502(b)(2). Although conceding Liberty's entitlement under state law to allocate recoveries first to interest, the Opposition seeks to extend section 502(b)(2) to prohibit Liberty's collection of post-petition interest from its non-debtor guarantor, GTN.[3] This argument fails, given the bankruptcy court's undisturbed findings that "[t]he payment of interest by GTN does not diminish this estate," and Liberty's allocation of the GTN funds to interest first was "commercially reasonable". App. 36a, 37a. This case is not about Liberty unfairly "characterizing" its unpaid claim as one for principal. Rather, it is about the Fourth Circuit's

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[3] By extending the "unmatured interest" bar to non-debtor guarantors the Opposition also violates Bankruptcy Code § 524(e), which preserves creditors' rights against non-debtors.

decision, for largely unarticulated reasons, to disallow a principal claim as if it were an interest claim in the face of established facts and law to the contrary.

The Fourth Circuit maintained it did not impair Liberty's valid claims and state law rights, offhandedly suggesting that "Liberty is free to . . . pursue collection from GTN at any time." App. 11a n.5. But Liberty had already collected what it could from GTN; the Fourth Circuit merely gave lip service to Liberty's freedom under state law to collect and allocate payments from GTN, as shown by its ruling "that Liberty may not affect the rights of a party in bankruptcy by its classification of a payment received from a non-debtor guarantor." *Id.* This ruling disregarded state law (and created a new bankruptcy rule), overturning Liberty's payment allocation because the Fourth Circuit erroneously concluded ET Power's estate would benefit from a different allocation outcome.[4]

The Fourth Circuit's invocation of vague, equitable powers to override state law contract claims is the same kind of judge-made rule the Ninth Circuit used in *Fobian v. Western Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991). The *Fobian* rule barred allowance

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[4] Under any scenario, ET Power will make the same bankruptcy distribution on the $140 million principal claim as it makes on other claims. If Liberty is entitled to a distribution of $17 million of principal on its $140 million claim (GTN already paid $123 million), then GTN may assert as a subrogation claim the portion of the $140 million claim yielding Liberty more than $17 million. If Liberty cannot assert any claim against ET Power (on the theory that GTN paid $140 million in principal), then GTN can assert a $140 million claim against ET Power. Either way, ET Power makes the same aggregate distribution on a principal claim of $140 million.

of attorneys' fees relating to litigation of bankruptcy law issues, despite contractual provisions authorizing such claims. In *Travelers*, this Court firmly rejected such free-floating equity analyses that would disallow otherwise valid contract claims:

> The *Fobian* rule finds no support in the Bankruptcy Code, either in § 502 or elsewhere. In *Fobian*, the court did not identify any provision of the Bankruptcy Code as providing support for the new rule. See 951 F.2d, at 1153. Instead, the court cited three of its own prior decisions [citations omitted]. Significantly, in none of those cases did the court identify any basis for disallowing a contractual claim for attorney's fees incurred litigating issues of federal bankruptcy law.

Travelers, 127 S. Ct. at 1205. The ruling below suffers the same fatal defects.

II. Review Is Warranted To Address Conflict Among The Courts Of Appeals Regarding The Use Of Equitable Principles To Disallow Claims In Bankruptcy.

By assuming that broad equitable disallowance powers are somehow embedded in section 502, and by rephrasing the question presented here, the Opposition denies the existence of a split of authority among the circuits. According to ET Power, no conflict exists regarding section 502(b)(2)'s application to disallow an "unmatured interest" claim. But the improper recharacterization of Liberty's principal claim as interest

was the necessary predicate to its disallowance. Whether "equitable principles" allow federal courts in bankruptcy cases to recharacterize and disallow valid state law claims – authority that is not codified in section 502 – is undeniably the subject of an entrenched circuit split arising from application of section 510(c). As the codification of equitable disallowance and subordination case law under the former Bankruptcy Act,[5] section 510 is the only Bankruptcy Code section that expressly permits equitable principles to alter a bankruptcy creditor's otherwise valid and enforceable state law claim.

The Petition demonstrates a three-way split of authority among the circuits. The Sixth, Seventh, Eighth, Ninth and Tenth Circuits permit either equitable subordination or the complete disallowance of claims in bankruptcy pursuant to section 510(c), but only based upon a finding of misconduct. *See* cases collected at Pet. 14-15. No such "inequity" has been alleged here, much less proven. On the contrary, the bankruptcy court found that collecting interest first from GTN was commercially reasonable and did not adversely impact the estate. App. 36a, 37a. The Fifth Circuit takes a different approach, holding that inequitable conduct justifies equitable subordination under section 510(c), but not disallowance. *See* Pet. 13. The Fourth Circuit's ruling in this case has created the three-way split, holding that claims may be equitably disallowed *without any proof of inequitable conduct.* In so ruling, the Fourth Circuit contradicted its earlier decision requiring proof

[5] *See* 4 COLLIER ON BANKRUPTCY ¶ 510.LH (Alan N. Resnick & Henry J. Sommer eds., 15th ed., rev. 2007).

of misconduct as a predicate to equitable subordination of a claim. Pet. 14.

Whatever equitable powers bankruptcy courts have, they are not limitless, and must only be exercised within the statutory framework of the Bankruptcy Code. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988). Here, without authority under the Bankruptcy Code (indeed, in conflict with section 510(c)), the Fourth Circuit invoked equity to recharacterize and disallow Liberty's claim, thereby exacerbating an already existing split of circuit authority.

III. The Opposition's Authorities Regarding Section 502(b)(2) Actually Conflict With The Ruling Below.

With one negligible exception, none of the cases cited in the Opposition support the proposition that Liberty's claim constitutes unmatured interest that should be disallowed pursuant to section 502(b)(2). As ET Power admits, virtually *all* of the cases it cites actually "reached a different conclusion from that of the majority below." Opp. 18. Inadvertently, the Opposition establishes that the ruling below conflicts with Supreme Court and circuit authority on this very issue.

The Opposition showcases *Thrifty Oil Co. v. Bank of America National Trust & Savings Ass'n*, 322 F.3d 1039, 1047-48 (9th Cir. 2003), and the cases it cites. Opp. 15-19. Ironically, *Thrifty* was later overruled in part by *Travelers* because it applied the *Fobian* rule in disallowing attorneys' fees. *Travelers*, 127 S. Ct. at 1206-07. In *Thrifty*, the debtor contended that the

periodic payments and termination fees payable under its interest rate swap agreements with its lender constituted "unmatured interest." The *Thrifty* court rejected this argument. *Thrifty*, 322 F.3d at 1043, 1048-50.

Similar results obtained in the cases cited in *Thrifty*: the challenged claims were *not* disallowed as "unmatured interest." *See, e.g., LTV Corp. v. Valley Fid. Bank & Trust Co. (In re Chateaugay Corp.)*, 961 F.2d 378, 382 (2d Cir. 1992) (face value exchange of debt in consensual workout did not create "unmatured interest" in form of "original issue discount," so claims not disallowed); *Tex. Commerce Bank, N.A. v. Licht (In re Pengo Indus., Inc.)*, 962 F.2d 543, 549 (5th Cir. 1992) (same); *Mt. Rushmore Hotel Corp. v. Commerce Bank (In re Mt. Rushmore Hotel Corp.)*, 146 B.R. 33, 37 (Bankr. D. Kan. 1992) (discounted market price paid by bondholders did not constitute "unmatured interest"); *In re Skyler Ridge*, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987) (mortgage prepayment penalties do not constitute "unmatured interest" even though they protect realization of the contractual interest rate).

Nor does *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946),[6] support ET Power's argument. *Vanston* disallowed a fully secured creditor's claim against the estate for post-petition "interest on interest" (although allowing simple post-petition interest). After acknowledging that the claim was invalid in the first place under New York law, the Court reasoned that, even if valid under state law, interest-on-interest

[6] Opp. 16, 17, 24 and 27-29.

should not be allowed in that case because it would penalize the estate for not making simple interest payments the court suspended while it administered the case. *Id.* at 165-167. *Vanston's* rationale is inapplicable here: Liberty's claim is for principal only, and no similar "penalty" exists for making distributions of principal for which ET Power was indisputably liable.

Vanston does not in any way address nor restrict enforcement of post-petition interest *against parties other than the bankruptcy estate. Bruning v. United States*, 376 U.S. 358 (1964),[7] squarely addresses this issue, holding that post-petition interest could be enforced against an individual debtor who was not discharged of tax liabilities:

> The basic reasons for the rule denying postpetition interest as a claim against the bankruptcy estate are the avoidance of unfairness as between competing creditors and the avoidance of administrative inconvenience. These reasons are inapplicable to an action brought against the debtor personally.

Bruning, 376 U.S. at 362-63. *Accord Hanna v. United States (In re Hanna)*, 872 F.2d 829, 830-31 (8th Cir. 1989) (section 502(b)(2) only bars post-petition interest "against the bankruptcy estate;" post-petition interest is nondischargeable *and enforceable* against individual debtors who remain personally liable). For the same reason, enforcing a claim for post-petition interest

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[7] Opp. 18, 24 and 27.

against a non-debtor, third-party guarantor does not implicate section 502(b)(2). The very purpose of a guarantee is to collect amounts, such as unmatured interest, that are not allowable against a debtor. *See In re El Paso Ref., Inc.*, 192 B.R. 144, 146 (Bankr. W.D. Tex. 1996) (section 502(b)(2) bars unmatured interest claims against the estate, not against a guarantor); *Stoller's, Inc. v. Peoples Trust Bank (In re Stoller's, Inc.)*, 93 B.R. 628, 635-36 (Bankr. N.D. Ind. 1988) (same).

Similarly inapposite are most of ET Power's other authorities. They neither involved recharacterization of a claim for principal into an unmatured interest claim, nor the right to recover interest from sources other than the estate. *See, e.g., In re Fesco Plastics Corp.*, 996 F.2d 152, 156 (7th Cir. 1993) (rejecting creditors' request to override section 502(b)(2) and collect concededly unmatured interest on belatedly allowed claims to compensate for distribution delay); *Brown v. Sayyah (In re ICH Corp.)*, 230 B.R. 88, 96 (N.D. Tex. 1999) (remanding for trial on the factual issue of whether a transaction involved "original issue discount"); *United States v. Energy Res. Co.*, 495 U.S. 545, 551 (1990) (upholding debtor's right to direct the Internal Revenue Service to apply its tax payments first to extinguish trust fund obligations under a reorganization plan).

Only one case cited by ET Power held (without any substantive analysis and without citing or considering *Bruning*) that post-petition interest could not be collected from a non-debtor guarantor. Opp. 19-20. In *Aetna Business Credit, Inc. v. Hart Ski Mfg. Co. (In re Hart Ski Mfg. Co.)*, 7 B.R. 465, 469 (Bankr. D.

Minn. 1980), a decision not followed anywhere, the court reasoned that the guarantor was liable only for what the debtor owed, but inexplicably erred in concluding the debtor did not owe post-petition interest, whereas in fact the debtor *owed* the interest. Section 502(b)(2) merely prevented its allowance against the debtor's estate.

Ignoring this Court's ruling in *Bruning* and other authorities holding that section 502(b)(2) does not bar collection of post-petition interest from non-estate sources, ET Power suggests this Court should instead consider case law construing section 502(b)(6), which caps claims for lease "rejection" damages, such as *Solow v. PPI Enterprises, Inc. (In re PPI Enterprises, Inc.)*, 324 F.3d 197, 210 (3d Cir. 2003). Opp. 21-23. The distinctly different legislative histories and purposes of section 502(b)(2)'s bar on unmatured interest claims versus section 502(b)(6)'s landlord "cap" make the latter a very poor analogy. Moreover, contrary to the debtors' insinuation, *PPI* does not limit recovery against third parties. Rather, the decision emphasizes that, according to the lease terms at issue, the letter of credit and proceeds thereof constituted a security deposit, and therefore qualified as estate property to which the cap applied.[8]

ET Power's own authorities demonstrate that the Fourth Circuit's decision has created a conflict with this

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[8] Notably, the circuits are split on the treatment of letter of credit proceeds. *Compare PPI with EOP-Colonnade of Dallas Ltd. P'ship v. Dennis Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 269-70 (5th Cir. 2005) (cap applies only to claim against estate, and does not limit recourse to letter of credit proceeds).

Court's precedents and decisions from other circuits, and certiorari is warranted.

IV. This Case Presents An Issue Of Vital Importance On A Fundamental Proposition Of Bankruptcy Law.

Whether federal courts can resort to general principles of equity to eliminate allocation rights under guarantees and recoveries on valid state law claims in bankruptcy is a question implicated in "mega" cases under chapter 11, as well as individual cases under chapters 7 and 13. The division among the Courts of Appeals is real and pervasive, and is not likely to resolve itself absent this Court's intervention.

CONCLUSION

For the foregoing reasons, Liberty respectfully requests that this Court grant the Petition.

Respectfully submitted,

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IN THE

Supreme Court of the United States

LIBERTY ELECTRIC POWER, LLC,

Petitioner,

v.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.),

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

AMICUS CURIAE BRIEF OF COMMERCIAL FINANCE ASSOCIATION IN SUPPORT OF PETITIONER AND IN SUPPORT OF REVERSAL OF THE COURT BELOW

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INTEREST OF AMICUS CURIAE

Commercial Finance Association ("CFA") respectfully submits this *amicus curiae* brief pursuant to Supreme Court Rule 37.2 in support of petitioner Liberty Electric Power, LLC ("Liberty").[1] CFA is uniquely positioned to speak to the impact that the decision of the United States Court of Appeals for the Fourth Circuit (the "Fourth Circuit") in this case will have on the market for commercial credit. CFA is the principal United States trade association for financial institutions that provide commercial financing to obligors. CFA's some 300 members include substantially all of the major and regional banks in the United States, as well as other independent lenders of all sizes. Financing provided by CFA members – currently exceeding $489 billion in outstanding loans and advances under revolving credit agreements in excess of $2 trillion per year – comprises a substantial portion of the United States credit market. Most of the obligors served by CFA members depend upon this financing for working capital to operate and grow their businesses.

There is a strong correlation between the availability and cost of credit and the creditor's evaluation of the risk of non-payment. If a creditor perceives increased risks in recouping its money,

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[1] Pursuant to Supreme Court Rule 37.6, CFA states that no persons or entities other than *amicus curiae* made any monetary contribution to the preparation or submission of this brief and that no counsel for any party authored this brief in whole or in part. *Amicus* has given the parties more than ten days' notice of its intention to file this brief and the parties have consented to the filing. Written consent letters are on file with the Clerk's Office.

that creditor may decide not to extend credit, to extend less credit, or to extend credit at a higher interest rate. One of the major ways in which creditors address the risk of non-payment and control the cost of credit is through guarantees. By taking guarantees from qualified guarantors, creditors often are willing to extend credit to obligors who otherwise might not have access to it, to increase the amount of credit otherwise available to obligors, or extend credit at a lower interest rate.

The Fourth Circuit's decision has far-reaching, troubling consequences for the value of guarantees and, therefore, will have a significant adverse impact upon the availability and cost of credit. As a result, the CFA has a strong interest in the outcome of this case and urges the Court to grant certiorari to review the Fourth Circuit's decision.

SUMMARY OF ARGUMENT

In the instant case, arbitrators awarded the creditor, Liberty, $140 million of principal plus $17 million of interest that accrued after the obligor filed for bankruptcy. Liberty first sought to collect its claim from the guarantor, which paid Liberty $140 million (the amount of the contractual limitation in the guarantee). Liberty allocated the first $17 million of this payment to post-petition interest, which is permissible under applicable state law and which accords with prevailing financial practices. As it was entitled to do, Liberty filed a claim for $140 million against the obligor's bankruptcy estate, recognizing that it could only seek recovery of the remaining $17 million of unpaid principal. The bankruptcy and district courts allowed the $140

million claim and ruled that Liberty could recover distributions of up to the outstanding $17 million.

While acknowledging that Liberty had the right to assert the $140 million claim against the estate and the right to allocate the guarantor's payment as it wished *vis-à-vis* the guarantor, the Fourth Circuit nevertheless recharacterized the remaining $17 million of principal that Liberty sought from the estate as impermissible post-petition interest. It denied Liberty any recovery on the $17 million pursuant to § 502(b)(2) of the Bankruptcy Code, substituting undefined "principles of equity" for the bargained-for terms of a guarantee and long-standing applicable law.

There is no authority permitting § 502(b)(2) to be extended to a relationship between a creditor and a guarantor. The rejection of well-established law to the contrary and the revision of clear contractual provisions in favor of undefined equitable principles injects significant uncertainty into commercial lending. This uncertainty alone will reduce the availability of credit and drive up its cost.

Moreover, while the Fourth Circuit purports to rely on equitable principles to benefit the debtor's estate, the decision in reality has no beneficial impact on debtors. Instead, it only serves to lessen the overall value of guarantees by making the order and timing of a creditor's collection efforts dispositive of whether those efforts will be successful. The inevitable consequence of the Fourth Circuit's decision is that creditors will be less inclined to accept a limited guarantee and will become more selective with respect to whom they

accept as a guarantor. Because guarantees are so critically important to commercial finance transactions as a form of third-party credit support, anything that impairs their value or utility will have an adverse impact on the availability and cost of credit and, thus, on the financing of businesses and ventures.

ARGUMENT

I. THE FOURTH CIRCUIT'S EXPANSION OF § 502(b)(2) TO THE RELATIONSHIP BETWEEN A CREDITOR AND A NONDEBTOR THIRD PARTY FINDS NO SUPPORT IN BANKRUPTCY LAW.

The majority improperly extends § 502(b)(2) of the Bankruptcy Code to interfere with the relationship between a creditor and a nondebtor third-party guarantor. In doing so, the Fourth Circuit reverses almost 100 years of well-settled law that, except where bankruptcy law requires otherwise, bankruptcy provisions should not impact relationships with nondebtor parties. *See, e.g.*, *Butner v. United States*, 440 U.S. 48 (1979); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946); *Am. Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261 (1914). The purpose of § 502(b)(2) is to preclude creditors from receiving unmatured post-petition interest from a debtor's estate. It has not been, and should never have been, applied to an independent, bargained-for contract between a creditor and a nondebtor guarantor. Yet the Fourth Circuit has effectively expanded the reach of § 502(b)(2) to preclude a creditor from receiving post-petition interest from a guarantor

notwithstanding the specific terms of their agreement. As the dissenting opinion notes, the majority "would have the bar to recovery of interest from the debtor swallow the accrual of interest on the debt across all parties liable for it." Appendix ("App.") A to Liberty Electric Power, LLC's Petition for a Writ of Certiorari ("Cert. Pet."), at 16a.

The dissent is correct that there is "nothing in the Bankruptcy Code, applicable case law, the relevant guarantee agreement, or nonbankruptcy law to support the jettisoning of basic contract law principles in favor of an expansive reading of § 502(b)(2)." App. A at 16a. Indeed, the Fourth Circuit supplants both the terms of the parties' contract and applicable non-bankruptcy law with undefined "principles of equity" in order to expunge the creditor's claim. App. at 9a. Although § 105 of the Bankruptcy Code gives the bankruptcy court certain equitable powers, the exercise of those powers must be tied to some other provision of the Bankruptcy Code. *Joubert v. ABN AMRO Mortgage Group, Inc. (In re Joubert)*, 411 F.3d 452, 455 (3d Cir. 2005); *Disch v. Rasmussen*, 417 F.3d 769 (7th Cir. 2005); *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.)*, 351 F.3d 86, 92 (2d Cir. 2003). The Fourth Circuit failed to offer any Bankruptcy Code provision to justify its "equitable" transmutation of Liberty's principal claim into a claim for post-petition interest. Rather, invoking unspecified equitable principles, the Fourth Circuit simply deemed Liberty's state law claim for unpaid principal to be one for post-petition interest, and then disallowed the interest claim under § 502(b)(2).

But the plain terms of the statute itself did not apply to Liberty's unpaid principal claim, nor do they dictate that result.

II. THE FOURTH CIRCUIT'S EXPANSION OF § 502(b)(2) TO THE RELATIONSHIP BETWEEN A CREDITOR AND A NONDEBTOR THIRD PARTY INTERJECTS UNCERTAINTY INTO LENDING RELATIONSHIPS THAT WILL ADVERSELY IMPACT THE AVAILABILITY AND COST OF CREDIT.

A. The Injection of Uncertainty Into Guarantee Transactions Harms Credit.

Although this case involves the use of undefined equitable principles to impair a guarantee, the majority's unprecedented tack creates significant uncertainty concerning the scope of a bankruptcy court's equitable powers, including its authority to rewrite contracts and agreements under the banner of equity, as well as uncertainty regarding the liability of a guarantor for post-petition interest, the validity of well-established case law, and the scope of § 502(b)(2). All of this uncertainty undercuts a creditor's ability to foresee and protect against risk and, therefore, necessarily impacts the availability and cost of credit. As the Seventh Circuit explained in *First Wisconsin Financial Corp. v. Yamaguchi*:

> Clarity is important to commercial transactions. The beneficiary of a guaranty relies on the undertaking in

> supplying credit. Unless the lender can determine the extent of its protection through objective criteria, the risk of doing business will go up, and with it the rate of interest charged for loans. Uncertainty thus injures honest, reliable debtors.

812 F.2d 370, 373 (7th Cir. 1987). The direct link between uncertainty and the cost of credit is unassailable. For example, in *In re Lifschultz Fast Freight*, a case involving the wrongful use of the equitable principle of subordination, the court observed:

> If a court wrongly subordinates a claim, other investors are sure to take heed. An investor will see that the chance she might not get her money back has gone up slightly. She will be less willing to lend or invest in the future; and the cost of credit will rise for all.

132 F.3d 339, 347 (7th Cir. 1997).

B. The Fourth Circuit's Decision Creates Significant Uncertainty for Lenders and Other Creditors.

In situations where a creditor bargained for a guaranty of principal and interest and the guarantor is unable to pay the principal debt and interest in full, either because of an express contractual limitation on the guarantor's liability as in the case at hand, or because of a *de facto* limitation resulting from the guarantor's financial inability to pay the

entire guaranteed debt in full, the Fourth Circuit ruling erroneously makes a creditor's recovery dependent upon the order and timing of the creditor's collection efforts. Had Liberty sought to recover its $140 million claim of principal against the bankruptcy estate first, and had it received a distribution of at least $17 million from the estate, Liberty presumably would have been able to collect the entire remainder of its full $157 million claim from the guarantor, the very result contemplated by the three-party transaction.

Thus, the Fourth Circuit's ruling unfairly presents the creditor with a Hobson's choice: either it (i) exercises its right to collect first from the guarantor and thereby gives up its right to collect any remaining principal from the debtor (the result in the case at hand) or (ii) looks first to the bankruptcy estate before seeking redress from the guarantor. The first alternative is unfair because it imposes a substantial financial penalty on a creditor for exercising its bargained-for right to proceed first against the guarantor. The latter alternative is unfair because it incentivizes a creditor to exhaust its collection remedy against the debtor before proceeding against the guarantor. This option has the practical effect of converting a guarantee of payment (under which the guarantor is obligated to pay as soon as the debtor fails to make a payment when due) into a much less valuable guarantee of collection (under which the guarantor is only required to pay after the creditor's legal efforts to collect from the debtor have been exhausted). Peter A. Alces, THE LAW OF SURETYSHIP AND GUARANTY § 1:7 (West 2003). In so doing, the court is not only

"jettisoning" basic contract law principles, as the dissenting opinion noted, App. A at 16a, but is rewriting contracts between creditors and nondebtor, third-party guarantors. This is prohibited for good reason:

> Courts may not convert one form of contract into the other after the fact, without raising the cost of credit or jeopardizing its availability. Unless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized.

Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1356-57 (7th Cir. 1990).

A creditor who chooses to go to the bankruptcy estate first will not only incur additional legal costs by participating in the debtor's bankruptcy proceeding to its conclusion, but may be forced to wait years before receiving a distribution from the estate.[2] Moreover, the creditor is exposed to the additional risk that, when it finally turns to the guarantor for payment of the remaining amount, the guarantor's financial condition will have

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[2] Under this approach, if the creditor seeks to mitigate the delay in obtaining a distribution, and to minimize legal costs, it would presumably exercise whatever leverage it has in the bankruptcy case to secure a quick distribution through liquidation instead of reorganization. Liquidation, however, may not be the best result for the debtor and its creditors. Ironically, therefore, while the Fourth Circuit's purported goal in the instant case is to aid the debtor's estate, it may actually detract from reorganizing the debtor's affairs under chapter 11.

deteriorated. Because of all of the risks and delays attendant to the second choice, it is a wholly impractical option for most creditors.

As a practical matter, a creditor is still likely to seek payment first from the guarantor. The inevitable offshoot of the Fourth Circuit's decision, however, is that creditors will refuse to accept limited guarantees, and will raise the bar as to whom may be considered to be an acceptable guarantor, a result that will have a depressing impact on the availability and cost of credit.

III. THE DECISION'S ADVERSE IMPACT ON CREDIT HAS NO COUNTERVAILING BENEFIT FOR DEBTORS' ESTATES.

By basing its decision on unspecified equitable principles, the majority presumably believes that the decision will benefit debtors or their estates. The decision's impact on the value of guarantees and on the availability and cost of credit is particularly unfortunate, however, because the perceived equitable result that is the premise of the ruling is illusory, as the ruling is cash neutral to the debtor's estate.

Assume, for the sake of illustration, that the debtor's estate is paying out a 25% bankruptcy distribution.[3] Assume further that the guarantor will enforce its right of subrogation. *See* 11 U.S.C. § 509(a); *see also* Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L.

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[3] The selection of 25% is arbitrary; however, the relative results are the same regardless of the assumed distribution.

REV. 47, 60 (Winter 1999); *In re Doctors Hosp. of Hyde Park, Inc.*, 474 F.3d 421, 427 (7th Cir. 2007).[4] To assess the impact of the Fourth Circuit's ruling, it is necessary to analyze what the creditor, the debtor and the guarantor would receive or pay under the Fourth Circuit's ruling, and contrast that to what they would receive or pay under this Court's rulings and those of other circuit courts.

Under the scenario that existed prior to the Fourth Circuit's ruling, and that exists in other circuits, *see* Cert. Pet. at 12-17, Liberty first receives $17 million of interest and $123 million of principal from the guarantor to reach the contractual cap of $140 million. Even though Liberty has a $140 million claim in the bankruptcy, its potential recovery is limited to the unpaid principal of $17 million, which it then receives from the debtor's estate. The guarantor would then step into Liberty's shoes and recover a 25% distribution on Liberty's $140 million bankruptcy claim, minus the $17 million that Liberty has already received. The net effect under this scenario is that the debtor pays a total of $35 million, representing a 25% distribution on the $140 million petition-date claim.

In contrast, under the Fourth Circuit's decision, Liberty has received $140 million from the guarantor, but cannot recover the remaining $17

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[4] If the guarantor has satisfied the obligor's obligation to the creditor, the guarantor is equitably subrogated to the creditor's rights against the obligor. Katz, *supra*, at 60. If the obligor is in bankruptcy, § 509(a) of the Bankruptcy Code allows the guarantor to step into the shoes of the creditor and to assert the creditor's petition-date claim against the obligor. 11 U.S.C. § 509(a).

million of unpaid principal from the debtor because the Fourth Circuit has recharacterized it as post-petition interest. The debtor pays nothing to Liberty; however, the guarantor steps into Liberty's shoes and receives a 25% distribution from the debtor on Liberty's $140 million claim. The net effect is that the debtor has still paid $35 million, representing a 25% distribution on the $140 million petition-date claim.

This exercise exposes the fallacy of the Fourth Circuit's ruling. While Liberty is precluded from recovering from the debtor the remaining $17 million in principal it is owed, the Fourth Circuit has revised the guarantee contract with Liberty and conferred a windfall on the guarantor at the creditor's expense with no benefit to the estate. Instead of Liberty receiving the first $17 million of the amount distributed on the $140 million claim ($35 million in the example), with only the balance ($18 million in the example) distributed to the guarantor on its subrogation claim, the guarantor will now receive on its subrogation claim the full distribution ($35 million in the example), resulting in an unwarranted benefit to the guarantor of $17 million.

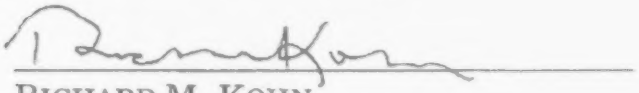
There is no basis in law or equity for the guarantor to receive this benefit at the expense of the creditor. Ironically, the transaction is a wash for the debtor's estate, which still pays a distribution on the subrogated $140 million claim allowed under § 502(b)(2). Thus, the Fourth Circuit's entire justification for substituting purported equitable principles for an appropriate result under state law and the terms of the guarantee is illusory.

CONCLUSION

The Fourth Circuit's decision is not only erroneous as a matter of law but, if left undisturbed, will also inject significant uncertainty into the credit markets, disrupt reasonable commercial expectations and reduce the availability, and increase the cost, of commercial credit. The far-reaching implications of this decision on the United States credit markets cannot be underestimated.

The petition for writ of certiorari should be granted.

Respectfully submitted,



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